2
Types of Financial Institution

2.1 Introduction

Whilst ERM can be applied to any organisation, this book focusses on financial institutions, concentrating on the following four broad categories of organisation:

- banks;
- insurance companies;
- pension schemes; and
- foundations and endowments.

There is, of course, an enormous range of financial institutions, many of which are not covered in as much detail as those above. For example, investment (or asset) managers are an important feature of the financial landscape. However, their involvement with financial markets does not involve taking significant balance sheet risk in relation to the investment decisions made; rather, investment managers are responsible for investing assets on behalf of institutions and individuals. As such, their main role is as agent. A similar argument can be made for brokers, whose aim is typically to act on behalf of clients when trading securities.

It is also important to note that there are links between the four institutions listed above. Insurance companies will frequently sell policies to pension schemes, sometimes even taking on all liability for pension scheme members. Furthermore, banks will have both insurance companies and pension schemes as clients.

Before looking at the risks that these four organisations face, it is important to understand their nature. By looking at the business that they conduct and the various relationships they have, the ways in which they are affected by risk can be appreciated more fully. This is the first – and broadest – aspect of the context within which the risk management process is carried out.
2.2 Banks

A direct line can be drawn to current commercial banks from the merchant banks that originated in Italy in the twelfth century. These organisations provided a way for businessmen to invest their accumulated wealth: bankers lent their own money to merchants, occasionally supplemented by additional funds that they had themselves borrowed. The provision of funds to commercial enterprises remains a core business of commercial banks today.

By the thirteenth century, bankers from Lombardy in Italy were also operating in London. However, a series of bankruptcies resulted in the Lombard bankers leaving the United Kingdom towards the end of the sixteenth century, at which point they were replaced by Tudor and Stuart goldsmiths. These goldsmiths had moved away from their traditional business of fashioning items from gold, starting instead to take custody of customers’ gold for safekeeping. Following on from a practice devised by the Italian bankers, these goldsmith-bankers gave their customers notes in exchange for the deposited gold, the notes being the basis of the paper currency used today. There also existed a clearing network for settling payments between the goldsmith-bankers. Much of the deposited gold was then invested, with only a proportion retained by the goldsmith-bankers. This forms the basis for what is known as fractional-reserve banking, where only a proportion of the currency in issue is supported by reserves held.

Over time, the banking industry grew. In London, goldsmith-bankers were joined by money scriveners who acted as a link between investors and borrowers, and by the early eighteenth century the first cheque accounts appeared.

For much of the history of banks, particularly before the twentieth century, the industry was characterised by a large number of local banks. This meant that banks did not really need a network of branches. The location of the bank also reflected the clientele it served. In the United Kingdom, banks based in the City of London were more likely to be merchant banks, whilst banks in the West End of London were more likely to serve the gentry. These West End banks took deposits and made loans (often in the form of residential mortgages), but were mainly involved in settling transactions. Smaller firms, as well as wealthy individuals, often found their needs served by the local (or country) banks of the eighteenth and nineteenth centuries. Following many mergers, these firms developed into the ‘high street’ banks seen today in the United Kingdom and elsewhere. Today, they raise capital from equity shareholders and bondholders, but also from holders of current and savings accounts with the bank. These funds are then used to fund short-term unsecured loans and longer term mortgages to individuals and to firms. Many banks also lend funds to each other in order to make use of surplus capital or, as borrowers, to obtain additional finance. This lending is generally done over the short-term. A final
and important function of many of these institutions is as clearing banks. This is the process by which transactions are settled between as well as within banks, a function that can be traced back to some of the earliest work carried out by the goldsmith-bankers in the seventeenth century.

Although high street banks are now limited liability firms, this structure developed relatively recently. Following legislative changes in the early eighteenth century, all banks in England were restricted to partnerships with six or fewer partners. The only exception was the Bank of England, which was a joint-stock bank with limited liability. This restriction remained until legislation allowing the formation of new joint-stock banks was introduced in the nineteenth century. Some banking partnerships do still exist, being more commonly referred to as private banks today, but most banks are now owned by shareholders, being publicly traded companies or corporations. However, another form of bank, predominantly in the retail sector, is the mutual bank. A mutual bank is owned by savers with and borrowers from the bank, rather than by shareholders or partners. In the United Kingdom, the dominant form of mutual bank is the building society, whose main purpose is to raise funds which are then lent out as residential mortgages. The first building societies were set up in the United Kingdom in the late eighteenth century. They were generally small organisations whose customers lived close to each society’s headquarters, and whilst there are now building societies operating on a national basis, many of these small, local firms still exist. This is in contrast with the consolidation seen in the rest of the banking sector.

Compared with building societies, investment banks are a much more recent phenomenon. Their original role was to raise debt and equity funds for customers, and to advise on corporate actions such as mergers and acquisitions. These activities are still undertaken, but today investment banks also buy and sell securities and derivatives. In some cases, this is with the intention of holding a position in a particular market, for example, being an investor in equities. However, in other cases the aim is for the bank to hold a ‘flat book’ – for example, to take on inflation risk from a utility firm and to provide inflation exposure to a pension scheme. The range of investment positions that a bank can hold is huge, and the potential links between the various exposures that a bank holds can lead to large risks. It is important that the impact of each risk on the bank as a whole is well understood. Investment banks are also involved in taking on risk in the form of securities or derivatives and repackaging these risks for sale to other investors. The best-known examples are the asset-backed security (ABS) and mortgage-backed security (MBS). These provide a way of turning a bank’s loans into a form of security held at arm’s length from the bank. As a result, the risk and reward of the loans is transferred from the bank to a range of investors.

These days, investment banks and merchant banks exist together as departments
in more general commercial banks. However, this arrangement has only recently become possible internationally. In the United States, the US Banking Act of 1933, known as the Glass–Steagall Act, required the separation of merchant and investment banking activity in that country. This act was only effectively repealed by the US Financial Services Modernization Act of 1999, known as the Gramm–Leach–Bliley Act. This latter piece of legislation led to the existence of more broadly-based commercial banks, serving all of the needs of commercial customers.

Many of these retail banks also merged with commercial banks, so offering the full range of services to the full range of clients. Furthermore, many banks have merged to form groups catering for both commercial and retail customers, and many have gone further, adding insurance products to their range, the resulting organisations being known as ‘bancassurers’. The next section, however, considers the nature of insurance companies as distinct entities.

### 2.3 Insurance Companies

There are two ways in which insurance companies can be classified. First, there are life insurance (or assurance) firms, whose payments are contingent on the death or survival of policyholders; then there are non-life (or general, or property and casualty) firms. It is true that, technically, insurance is intended to replace the loss of a policyholder whilst assurance is intended to compensate for that loss (so a life cannot be insured). It is also true that non-life insurance is not a particularly specific term. However, because the terms life and non-life insurance are nonetheless broadly understood, only these terms are used.

Non-life insurance appears to have started in fourteenth century Sicily, with the insurance of a shipping cargo of wheat, and such policies had made their way to London by the fifteenth century. Life insurance came out of marine insurance, with the cover being extended to people travelling on a voyage. Insurance companies started to appear in the late seventeenth century, initially providing buildings insurance, not least as a response to the Great Fire of London in 1666. At around the same time, a specialist market for marine insurance was forming in what later became Lloyd’s of London. Today, Lloyd’s and the London Market constitute an international centre not just for marine and aviation insurance, but also for unusual risks such as satellite insurance and, more famously, the body parts of various celebrities (the fingers of Rolling Stones guitarist Keith Richards, for instance).

Lloyd’s provides a framework for risks to be covered. The capital for this used to be provided by individuals who had unlimited liability for any losses. More recently, limited liability capital has been used to support risks, this capital coming from insurance companies.

Many insurance companies are themselves limited liability organisations, known
as proprietary insurance companies. However, not all insurance companies are capitalised solely with shareholder’s funds. Many are mutual insurance companies owned by their policyholders. These with-profits or participating policyholders derive returns, at least partly, from non-profit or non-participating policyholders due to the fact that the former provide capital to support business written to the latter. It is also worth noting that some proprietary insurance companies also write with-profits business. This business is supported partly by the capital of with-profits policyholders and partly by shareholder capital.

The class of mutual insurers also includes friendly societies, which came into existence in the eighteenth century. These institutions offered (and still offer) benefits on sickness and death.

Marine, aviation and satellite insurance have already been discussed. However, the full range of insurance classes is enormous. The three classes above are all forms of non-life insurance and are generally (although not exclusively) written for corporate clients. Car insurance, on the other hand, is predominantly provided to individuals, as is insurance for household buildings and contents. A particularly important class is employer liability insurance. This covers, among other things, injury to employees during the course of their work. However, some types of injury may not become apparent until many years after the initial cause. A prime example of this is asbestosis, a lung disease arising from exposure to asbestos dust. Claims on many policies held by firms that used asbestos did not occur until many years after the industrial injuries had occurred. These so-called ‘long-tail’ liabilities, which resulted in the restructuring of Lloyd’s of London, demonstrate another distinction between different classes of insurance. For some classes such as employer liability insurance, the claims can occur for many years after the policy year; conversely, the claims for ‘short-tail’ insurance classes, such as car insurance, are mostly reported very soon after they are incurred. These differences lead to a difference in the importance of the various risks faced by insurers.

Life insurance has short- and long-term classes, although most fall into the latter category. However, life insurance is not generally long-tail, as claims are typically made and settled soon after they are incurred, even if they occur many years in the future. An example of a short-term class would be group life insurance cover, where a lump sum is paid on the death of an employee (often written through a pension scheme for tax reasons). These policies are frequently annual policies, and deaths are generally notified soon after they occur, not least because there is a financial incentive to do so. However, individual life insurance policies can have much longer terms. Term assurance – a life insurance policy often linked to a mortgage – will regularly have an initial term of 25 years. Also in existence are whole-life policies which, as the name suggests, remain in force for the remaining lifetime of the policyholder. On the other side of the equation from these policies that pay out
on death are annuities which pay out for as long as an annuitant survives. These too have risk issues linked to their long-term nature.

Life insurance companies also provide a variety of investment policies for individuals and institutions such as pension schemes. Some of these are unit-linked, where the return for the policyholder is simply the return on the underlying assets (after an allowance for fees). In this sense, the insurance company is acting as an investment or fund manager. However, there are two aspects of life office investment products that can differ from other products. The first is the with-profits policy. As mentioned above, these policies provide a return based not only on the underlying investments held in the with-profits fund, but also from the profits made from writing non-profit business such as life insurance policies or (non-profit) annuities. However, another important aspect of with-profits policies is that the returns to policyholders are smoothed over time. This is done by paying a low guaranteed rate on funds, and then supplementing this with bonuses. Bonuses are paid each year and at the end of a policy’s life. When investment returns are good, not all of these returns are given to policyholders; when they are poor, the bonus may be lower, but a bonus will generally be given. This means that not only is there smoothing, but for most with-profits products, the value cannot fall.

Whilst the typical with-profits products are investment funds, often in the form of endowment policies which pay out on a fixed date in the future, there are also with-profits annuities which apply a type of bonus structure to annuity payments. Some with-profits policies have also included options allowing investors to buy annuities at a guaranteed price. Since these guarantees were given many years before the options were exercised, the risks taken were significant and, in one case, resulted in the firm writing those policies being unable to meet its obligations.

Many insurance companies offer both life and non-life insurance policies. Such providers are known as composite insurers. In the European Union, the creation of new composite insurers is banned by the EEC First Life Directive 79/267/EEC (1979), except when the life component relates only to health insurance.

2.4 Pension Schemes

As with banks and insurance companies, pension schemes have a long history. Occupational pension schemes date back to the fourteenth century in the United Kingdom, with schemes providing lifetime pensions on retirement appearing in the seventeenth century in both the United Kingdom and France. The United States eventually followed suit in the nineteenth century. Defined benefit pension schemes, with a format similar to that in place today, also appeared in the nineteenth century in the United Kingdom. These are schemes where the benefit paid is calculated according to some formula, generally relating to the length of an individual’s ser-
vice with a firm and their earnings. The most common form of defined benefit arrangement is a final salary scheme, where the benefits are based on the salary immediately prior to retirement.

These types of arrangements were generally pay-as-you-go (PAYG) arrangements, as were the universal pension systems appearing in Germany in the nineteenth century, and in the United Kingdom and the United States in the twentieth century. This means that no assets were set aside to pay for the pensions – the cost was met as pensions fell due. This model is still the typical method used for state pension schemes, particularly in the United Kingdom. Many of these schemes have grown so large in terms of liabilities that capitalisation is no longer a viable proposition.

Funded pensions, where assets were set aside to pay for pension benefits, found popularity in the twentieth century with schemes being set up under trust law in the United Kingdom. This arrangement had a number of tax advantages for firms, contributions having been exempt from tax since the mid-nineteenth century. However, investment returns also received exemption in the early twentieth century. With funded pension schemes this means that both the benefits due and the assets held in respect of those benefits need to be considered. Virtually all defined benefit pension schemes present today in the United Kingdom were set up under trust law. Although set up by an employer, such schemes are governed by a group of trustees on behalf of the beneficiaries.

From the 1970s onwards, the regulation of defined benefit pension schemes increased, particularly in the United Kingdom. What was previously a largely discretionary benefit structure changed to one that carried a large number of guarantees. This changed fundamentally the degree of risk carried by pension schemes, and the employers (sponsors) that were responsible for ensuring that the pension schemes had sufficient assets.

Although it is not always the case, unfunded, PAYG pension schemes are still generally found in the public sector, and funded pension schemes, where assets are held to cover the benefits due, are found in the private sector. A ‘middle ground’ between these two types of scheme is the book reserve scheme. Here, the capitalised value of the liabilities is assessed but is held as a liability on the balance sheet rather than being run as a financially separate, funded entity. Such schemes have been popular in Germany, particularly prior to the provision of tax incentives for funded arrangements.

Whilst defined benefit pension schemes are still by far the most important type of retirement arrangement, increasing costs and an increasing appreciation of the risk they pose has led to a large increase in defined contribution pensions. Here, assets are accumulated – usually free of tax – and they are then withdrawn at retirement. In the United Kingdom, there was a requirement that 75% of the proceeds were
used ultimately to buy a whole-life annuity, with the remainder being available as a tax-free cash lump sum. However, whilst the tax-free lump sum still exists (as of 2016), individuals are now able to draw down the remaining assets – subject to tax at their marginal rate – as quickly or as slowly as they like. This brings the United Kingdom into line with countries such as the United States and Australia. However, it is worth noting the differences in approaches to taxation. The system in the United Kingdom and United States can be characterised as exempt-exempt-taxed, or ‘EET’ – that is, contributions are paid from pre-tax income, and they accrue investment returns free of tax, with tax being paid when funds are withdrawn. In Australia, the system is instead taxed-taxed-exempt. The effective tax on contributions and on returns is lower than for non-pension products, so the system could be characterised as ‘ttE’.

Whereas the majority of the risk in a defined benefit arrangement lies with the sponsor, in a defined contribution scheme it rests with the scheme member. In the United Kingdom, many defined contribution schemes set up in the past were trust-based schemes. However, an increasing number of defined contribution pension arrangements, whether arranged by an employer or not, are actually held as policies with insurance companies. This became even more common after the introduction of personal pensions in 1988.

2.5 Foundations and Endowments

The final types of institution are the broad group that can be classed as foundations and endowments. For the purposes of this analysis, these are institutions that hold assets for any number of reasons. They might be charities or individual trust funds; they might have a specific purpose such as funding research, or a more general function such as providing an income to a dependent; however, the common factor is that they do not have any well-defined pre-determined financial liability.

Some of these institutions will be funded by a single payment (endowments) whilst others will be open to future payments and may even have ongoing fundraising programmes (foundations). These imply very different levels of risk.

In the United Kingdom, the most common type of foundation is the charitable trust, this structure giving beneficial tax treatment. Some such organisations, like the British Heart Foundation, have the term ‘foundation’ in their name; however, this is an exception. Terms such as ‘campaign’, ‘society’ and ‘trust’ are just as likely to be found, as are names which have no reference to their charitable status.

Endowments are most commonly seen in the context of academic posts, such as the Lucasian Chair in Mathematics at the University of Cambridge. This practice has existed since the start of the sixteenth century in the United Kingdom.
the United States endowments are also used to finance entire institutions such as universities or hospitals.

2.6 Further Reading

Information on the early history of banking was provided by the Goldsmiths’ Company in the City of London. They were helpful in directing me to a number of useful publications, including Gilbart (1834) and Green (1989). There are also a number of popular books dealing with the development of individual banks, such as Chernow (2010) (‘The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance’) and Fisher (2010) (‘When Money Was In Fashion: Henry Goldman, Goldman Sachs, and the Founding of Wall Street’). More information on Lloyd’s of London is available in Lloyd’s of London (2006).

A good early history of pensions and insurance is given by Lewin (2003). The developments in pensions around the start of the twentieth century are covered in detail by Hannah (1986), with more recent legislative developments being discussed by Blake (2003).

Questions on Chapter 2

1. State the historical and current roles of investment banks.
2. Define the terms ‘long-term’ and ‘long-tail’ in relation to insurance.
3. Distinguish between defined contribution and defined benefit pension schemes.