

The new financial services leviathans: has competition been a casualty of the financial crisis?

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The debate

Introduction

This paper offers a thematic summary of discussions from our second event, which was held on 15th September 2009. Our paper author, Professor John Kay, set out his views in a discussion paper which you can download from www.focusonfinance.org.uk

The debate will be used to inform Consumer Focus' policy development, but the summary below should not be taken as Consumer Focus policy.

The central theme of the second debate was whether there is a trade-off between competition in financial services and overall financial stability, and how much competition in the financial services market is desirable from the consumer point of view.

There has been significant consolidation in the retail financial services sector as a result of the financial crisis – the merger of Lloyds TSB and HBOS, the takeover of Abbey by Santander, and considerable mergers in the building societies sector have all had an impact on competition.

Government intervention through the asset protection scheme and direct recapitalisation has also had an impact on the market – explicit government guarantees for existing market players may distort competition, and can be a barrier for new entrants into the financial services market. This seminar was an opportunity to explore some of these themes and to debate the impact on the consumer, and to discuss the way forward.

The emergence of financial conglomerates: is narrow banking the solution?

'The trend to specialisation was accompanied by a trend to diversification. Traditional banks became financial conglomerates. They not only sold a wider range of retail products but also expanded their wholesale market and investment banking activities. The bizarre consequence was that while the deposit taking and lending operations of banks could – and did – use new markets to limit their risks, speculative trading in the same markets by other divisions of the same banks would increase the overall risk exposure of the bank by far more'

Professor John Kay

In his paper, Professor John Kay argues that the process by which retail banks became financial conglomerates 'ended in tears' in 2007-8. The globalisation of financial markets coupled with deregulation intensified international competition. Competitive pressures encouraged traditional deposit taking retail banks to increase their exposure to wholesale financial markets, fuelling their growth. This growth came at the cost of higher risk exposures and the bubble finally burst, plunging the world into economic recession.

However, Kay argues there is not necessarily an inconsistency between competition and economic stability and that the best way forward is to break up 'the existing structure of banks along functional lines' which he argues 'is the essential means of achieving both stability and competition'.

Kay argued that having dedicated institutions focussed on the traditional model of retail banking is the best way to serve consumers and ensure stability in the financial system. Instead of chasing high value wholesale transactions, narrow banks can be more focused on providing a high quality service for the end consumer.

Whilst such a system may appear attractive at face value, key questions about the narrow banking model emerged from the debate:

- Could new entrants fit easily into the model of narrow banking?
- Wouldn't narrow banks require access to wholesale credit funding, and wouldn't this ultimately undermine the narrow banking model?
- Could narrow banks be the drivers of innovation with such limited business models?

Whilst it was acknowledged that a move towards a model of narrow banking is unlikely and would meet with considerable resistance from the

industry, participants at the seminar were of the view that more should be done by the government and regulators to promote competition in retail financial services. Many participants were of the opinion that a statutory objective to promote competition should be at the heart of any regulatory agency tasked with protecting consumers.

'You have to look at the way firewalls are constructed between different elements of the banking system. The narrow banking model seems to be designed for when times are hard and it may lead to a less competitive market, or less availability of competitive type services for small or medium size businesses and the individual consumer when times are more stable'

Paul Smee

There is a general recognition that competition is a force for good in financial services and that issues about financial stability are far more to do with incentives and the pricing of risk than they are to do with competition.

Financial stability: the role of competition

'Robust competition is essential for delivering the right outcomes for business and consumers. Once a solid framework for financial stability is in place, regulators should ensure the market remains competitive and that barriers to entry are addressed'

Cavendish Elithorn

'The most urgent mechanism of regulatory reform is to require firewalls and firebreaks between different activities. Such a change means reversing, at least in part, the conglomeration which was the central consequence of the deregulatory 'Big Bang' of the 1980s'

Professor John Kay

The general consensus of the discussion was that it is vitally important a vigorous mechanism for securing safety and stability within the financial services market is in place. Concerns are often expressed that too much competition can lead to instability in the financial services market. Critics frequently argue that when financial institutions are competing to offer the best interest rates for savers and lenders, they will inevitably turn to higher risk business models with significant exposures to the wholesale market, with the objective of offering more attractive financial products for consumers. This, it may be argued, leads to excessive risk exposure and results in financial

instability.

The consensus that emerged from the discussion, however, was that this is not necessarily the case and that healthy competition is vital to ensure consumers get a good deal. If banks focussed more on competing for consumers by providing a good service, rather than focusing on competing for a larger share of high value transactions in the wholesale sphere, consumers would be better off. Although competition is essential for a healthy financial services market, it is important that competitive pressures are always aligned with consumer interest and it should be the job of a regulator responsible for protecting consumers to ensure this.

Concerns were expressed at the seminar that retail banks are less anxious about customer reputation than they used to be. Whilst it is not necessary to name and shame clothing retailers because they are consumer focused and long term business depends on them maintaining a good reputation with customers, this is no longer the case with banks. It was also noted that building societies, essentially retail focused, often have better customer reputations than their banking equivalents, and in the past built up significant market shares on the basis of customer reputation – the regulatory system allowed the mutuals market to diminish and this has negatively impacted on the reputation of the retail financial services sector.

It was also noted that financial products are often *sui generis* – that is to say unique. It is usually obvious to the consumer when a product is not working e.g. it is noticeable when a car or a TV is not functioning. Financial products are often different because it can be difficult for the consumer to know whether they are working properly or not.

For a competitive market to work effectively for the interests of consumers, consumers must be able to exercise informed and unrestricted choice. As consumers often purchase financial products infrequently this is sometimes not the case and more should be done to promote financial capability to ensure that consumers can actively assert choices and preferences when purchasing financial products.

Barriers to entry

'Any form of selective government support distorts competition. To win such subsidy today, the firms concerned must be both large and unsuccessful. It is difficult to imagine a policy more damaging to innovation and progress'
Professor John Kay

It was acknowledged that tackling barriers to entry in the retail financial services market is key to the debate. With a couple of exceptions, most of the banks that exist in the UK today are the same banks that existed at the beginning of the last century. With the exception of the oil trade, in no other industry is this the case.

In his paper Professor Kay noted that new entrants are often the drivers of innovation and competitiveness in the market place. Take, for example, the airline industry. It is new entrants such as low cost carriers that have acted as catalysts to shake up the industry, making it far more competitive than it used to be. It is the same story in the telecommunications industry where new entrants have provided greater choice for the consumer. A consensus emerged in the discussion that it is therefore vital that barriers to entry are removed wherever possible.

The discussion also noted that government intervention in the wake of the financial crisis has distorted competition. Implicit government guarantees for risky banking activities for existing market participants present a barrier to entry for new institutions that do not have such an explicit guarantee of government support. The recapitalisation programme has also deflected the effects of competition – namely, that uncompetitive institutions fail at the expense of competitive, efficient institutions. Through government backing, recapitalised banking institutions are defended from normal market pressures at the cost of market efficiency and robustness of business models.

There is a lack of original models amongst new entrants and cultural change will be difficult to achieve unless competitors are of a sufficient scale to challenge the existing structure. There is also a lack of political will to act in a similar way to the energy industry for example, because investment banks are a huge political force.

Linked to this, participants also noted that one of the biggest barriers to entry at the moment is around consumer confidence and trust in financial services. It is vitally important that any regulatory framework designed to improve the safety of the sector is neutral to incumbent market players as well as new entrants. The special resolution regime, which is designed to guarantee a continuation of service in the event of institutional failure, should therefore help to restore trust and confidence in both established market players and new entrants.

Payments Systems

‘...competition both in processing payments or offering payments services to customers should be allowed to thrive’.

Paul Smee

The structure of the payments system is often viewed as being a significant barrier to entry. Collaboration is required to devise a set of common rules and procedures to ensure the payments system operates effectively.

Separation of the control of payments is difficult but it is recognised that competitive pressures in the processing of payments is desirable and should be enhanced.

John Kay’s paper argues that established banks have little to gain from changes to the payments system, and this is stifling competition in the retail payments area. He argues that many established institutions have struggled with the implementation of new payments technology and are reluctant to depart from the status quo. In addition to the predilection to stick with the current system, it is often difficult for new entrants to gain access to existing payments systems. Kay therefore argues that the structure of the payments system discourages innovation and is a clear barrier to entry for potential new market players.

Although the payments system does not always sit comfortably with unrestricted competition, it is inherently necessary for common standards and practices to be required of payments systems. This may pose a barrier to entry for some, but without effective standards the payments system would not function as it should.

The general consensus of the discussion was that barriers should be evaluated on a case-by case basis. They should be low and where there are barriers they should always be justified. Is the system for retail payments as innovative and competitive as the system for wholesale payments?

A key challenge ahead is to ensure that in the payments space the retail sector is given greater consideration.

Summary

This second seminar was an opportunity to discuss the merits of competition in retail financial services and provided a platform for the evaluation of the competitive effects of the government’s intervention in the market following the financial crisis.

A consensus emerged that competition is not

antagonistic with financial stability so long as checks are in place to ensure that competitive pressures are always aligned with the consumer interest.

A key problem is often that retail banks have focussed more on wholesale activities to gain a larger share of high value institutional transactions. They have been less focussed on customer reputation as a consequence, and this has impacted upon trust in financial services.

The seminar was also an opportunity to discuss the merits of Professor Kay’s solution – the implementation of a narrow banking model with dedicated institutions focussing exclusively on traditional retail banking type activities. The workability of the solution was questioned as the narrow banking sector still needs access to funding.

Participants at the seminar were adamant more should be done to promote competition in retail financial services, and that barriers to entry – including in the retail payments sphere – should be properly analysed and evaluated to ensure the retail market remains competitive and innovative for the benefit of the consumer.

You can listen to an exclusive podcast from the second debate at:

www.focusonfinance.org/debate2.html