



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

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## Introduction: the emergence of financial conglomerates

The traditional role of a bank was to take deposits, largely from individuals, and to make loans, mostly to business. In that world, the Bank of England acted as co-ordinator of a self-regulating club of financial institutions. The implicit deal was that financial institutions were permitted to act as a cartel in return for a commitment to conservative behaviour. In times of difficulty, they would provide mutual support, which the Bank would co-ordinate, in order to maintain financial stability. The Bank of England, in turn, acted as advocate of City interests within government.

That model functioned, with some degree of success, for most of the twentieth century. But it could not, and did not, survive the globalisation of financial markets and the deregulation and intensified international competition that followed. The world has changed. There is now no inconsistency between economic stability and a more competitive environment. Breaking up the existing structure of banks along functional lines is the essential means of achieving both stability and competition.

Financial innovation allowed banks to trade both credit risk and interest rate risk. These developments were at first called disintermediation and subsequently securitisation. Disintermediation undermined the traditional conception, and role, of a bank. Some commentators in the 1980s believed that the financial institutions of the future would be specialists. This perception was half right; all of the individual functions of established banks (with the possible exception of SME lending) are now also performed by specialist institutions.

But, paradoxically, 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.

In 2007-8, the process by which retail banks became financial conglomerates ended in tears. These financial conglomerates not only failed their shareholders: their customers had been victims of endemic conflicts of interest for years.



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Within every diversified retail bank, there was evidence of the fundamental tension between the cultures of buccaneering trading and the conservative bureaucratic approach appropriate for retail banking. It was a conflict in which the investment bankers and traders generally came out on top.

The attractions of financial conglomerates are more evident to the people who run them than to their customers, employees, shareholders – or the taxpayers who have been faced with bills of startling magnitude by their failure. The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities.

### **Too big to fail, too big to innovate**

Major banks have received massive government support because the organisation is viewed as 'too big to fail'. But neither a democratic society nor a market economy can contemplate such a concentration of unaccountable private sector power. Indeed 'too big to fail' destroys the dynamism that is the central achievement of the market economy.

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.

While in principle, there is no reason why disruptive innovations should not come from established, dominant firms in practice, the bureaucratic culture of these organisations inhibits it. Revolutions in business generally come from new entrants. Many of today's market leaders – Microsoft and Google, Vodafone and Easyjet – are companies that did not exist a generation ago. These companies could not have succeeded if governments had been committed to the continued leadership of IBM and AOL, AT & T and British Airways.

In UK banking, by contrast, all the leading banks today are the result of mergers between the banks which were the leading UK banks a century ago. The expansion of UK banking operations by the Spanish bank Santander through the acquisition of former building societies in the current crisis may be the most significant new entry into UK banking since the nineteenth century. Only the oil industry (which was insignificant in 1900) has shown stability of industrial structure remotely comparable to UK retail banking.

### **Using regulation to stimulate competition in financial services**

The financial services sector is only one of many regulated industries. Yet it is rare for discussion of financial services regulation to make reference to experience gained in other areas of regulation. We regulate utilities, such as gas, electricity, telecommunications and water; we regulate the transport infrastructure – railways, airports and airlines: we regulate broadcasting. All these industries have been restructured in the last three decades to introduce more targeted regulation and more effective competition. It is time to do the same in financial services.



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History shows that regulation works most effectively when it is focussed on a small number of clearly identified public policy problems. Most other industries are regulated, not supervised. Under nationalisation, government departments acted in effect as supervisors of industries within the sectors for which they were responsible. Since privatisation, such supervision has been replaced by focussed regulation and measures to promote competition, with generally beneficial results for efficiency and customer service.

In financial services, the terms regulation and supervision are used almost interchangeably. Yet they are not interchangeable. Supervision is, by its nature, wide-ranging: regulation is focussed. Despite the wide scope of supervision, it is not an effective method of regulation. It is subject to creep and capture and often supervisors are at a disadvantage to the management of firms in terms of quality of information available to it and competence of staff. Extensive and intrusive, yet ineffective and protective of the existing structure of the industry and the interests of its major players. That describes financial services regulation in Britain and abroad today.

### **Building a more resilient financial system by breaking up financial conglomerates**

In the financial system, as in all systems, mistakes and failures are inevitable. While good systems seek to reduce the likelihood of mistakes and failures, a central feature of all well designed engineering – and biological systems is that they are robust to the failures that will inevitably occur. Robust engineering systems are designed with modularity – so that one component can fail, and be replaced, with little damage to the whole. They have independent back-up systems. They are loosely coupled, so that small disruptions are easily absorbed. All financial institutions apply these principles to their technology, but similar measures are not in place – or widely thought relevant – to the substantive operations of these institutions, or for the financial system taken as a whole.

Modern developments in financial markets have made the system less, not more, robust. As a result relatively minor incidents proved massively disruptive; at AIG, 120 people in the financial products division, based in London, caused the failure of America's largest insurance company. This is the central problem that the financial services industry must address through systemic reform. 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.

Financial services companies should be structured so that in the event of an overall failure of the organisation the utility can be readily separated from the casino. That means the establishment of distinct narrow banks (see Box 1 below).

The claim that innovation in modern financial markets makes it essential to have large conglomerate banks is precisely the opposite of the truth – these innovations make it possible not to have large conglomerate banks. The activities of managing maturity mismatch, and spreading and pooling risks, which once needed to be



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conducted within financial institutions, now can, and should, be conducted through markets.

In a free market, narrow banking would have emerged spontaneously and immediately. As a result of recent history, depositors would strongly favour conservative, transparent institutions which eschewed complex financial instruments and demonstrated comprehensible balance sheets and organisational structures. The reason this outcome has not emerged is that government intervention has distorted the market. The outcome of market forces has been suppressed, and the natural outcome of market forces – narrow banking - should be imposed by regulation.

### **Box 1 – What might a narrow bank look like?**

Narrow banking implies the creation of banking institutions focussed on the traditional functions that the financial system offers to the non-financial economy.

#### **Core functions**

- Payments systems (national and international), for institutions of all sizes
- Deposit taking from individuals (perhaps up to £50,000 limit), and small and medium-sized enterprises.
- Might engage in consumer lending, lend on mortgage, and lend to businesses, but no monopoly over these functions.

#### **Ownership Structure**

- Could be subsidiaries of other companies. For example, Brit Bank might be the narrow banking subsidiary of the Brit Financial Group.
- Eventually some would become members of other groups, especially retailing groups. Others might be stand alone institutions.

#### **Regulation**

- Regulated, not supervised under the terms of a licence similar to those offered to our utility providers
- Only narrow banks could access the payments systems, or qualify for deposit protection
- Regulator would monitor compliance with rules governing narrow banks, but would not review the business strategies of banks or take a view on whether they are well run businesses.
- Some licence obligations would be of a general nature – protection of the interests of depositors – and others would be specific – the terms of access to the payment system.
- The licence would be capable of amendment, but not easily –utility legislation provides for amendment by agreement or, failing that, reference to the Competition Commission.



### **Payments – the heart of a competitive market in financial services**

Payment systems are the essential utility that the financial services industry provides to households and non-financial businesses. In the United States in March 1933, this utility failed. It has not done so anywhere during the 2007-9 crisis.

Payment systems are numerous, and proliferating, principally because the core systems have been slow to innovate and respond to changing needs. Many innovations are coming from businesses outside financial services, such as eBay and PayPal, from transport undertakings and their suppliers, and from phone companies.

The future could be different. There are two basic payments needs. One – the traditional role of cash – is for a portable mechanism of payment. Value is guaranteed; transactions can be undertaken anywhere, and can be anonymous. The other requirement, for higher value payments – the traditional role of the current account – requires access to the purchaser's deposit or line of credit with a financial institution.

Both needs can now be efficiently met by modern information technology. The first requirement needs an electronic wallet and the wide replacement of cash by prepaid storage cards. The second needs an online connection to a centre linked to financial institutions, providing low cost, real time, final electronic transfer of funds between individuals and businesses. If both systems were fully developed all payments could be made by waving a card or clicking a mouse. A world of simple, secure and cheap money transfer in which cash was mostly confined to illicit transactions would look very different. The social implications and savings to business could be substantial.

It is probably in the retail sector, rather than in wholesale markets, that opportunities for financial innovation with substantial economic and social impact are to be found today. But issues in retail banking receive little attention relative to those which arise in wholesale markets, and when bankers talk about innovation in financial markets, they are almost always talking about new products in wholesale markets (sometimes about new sales techniques in retailing) and almost never about improvement in the provision of core financial services.

Established banks do not have, or do not see themselves as having, much to gain from change, and many have struggled with the implementation of new technology platforms. Restricted access to the existing payment systems makes new entry in retail financial services more difficult. Charging structures for transactions frequently lack transparency and rarely bear any relationship to underlying costs.

In his report on UK banking in 2000, Don Cruickshank correctly identified the organisation of the payment system as a major obstacle to the development of a competitive retail market. He recommended that a payments regulator be established with power to set price caps and determine access provisions, on the lines of the utility regulators which exist for other infrastructure industries. This proposal was initially accepted by the government. It was, however, successively watered down in the face of industry lobbying, culminating in the establishment in 2007 not of a regulator but of a Payments Council, a membership organisation controlled by the industry (though with some independent representatives).



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It is time not only to revive Cruickshank's recommendation, but also to go further than he proposed. Narrow banks should in future be the only conduit to the payments system. Under narrow banking extensive reserve requirements are imposed on narrow banks. The principal reason for distinguishing real time gross settlement from delayed net settlement – the different amounts of collateral required to support transactions – consequently disappears. At the same time, a regulator might review the interchange fees imposed on merchants for credit card transactions – which have the effect of setting a floor to merchant acquisition charges.

It would be for the market, not the regulator, to decide the future shape of the payments system. But the regulator can, and should, give full rein to market forces. In other industries, such as electricity, the separation of the network from its suppliers has had a positive effect on competition, efficiency, and innovation. The UK has experienced a modest pace of innovation. New entrants to retail financial services have been obliged to partner well established firms to establish a market position. New developments in payments have taken place outside the established framework. There is considerable scope for enhancing competition, efficiency and innovation in this sector.

The utility model, which divorces control of the underlying infrastructure from product providers, offers a useful parallel. The objective might be Britpay plc, regulated by Paycom. Britpay might be owned, or perhaps franchised to, a consortium of technology companies rather than a consortium of banks, or perhaps be floated as an independent business. Breaking up the banks opens up a new range of options. There is plenty room for excitement in narrow banking.

But banking is not just about payments, but is the gateway to a wide range of financial services. Consumers are poorly informed about financial services products, easily misled, and have frequently been offered inappropriate services or ones that represent poor value. Many of them do not like dealing with financial matters. This information asymmetry provides a substantial justification for the regulation of financial services.

### **Increasing consumer power through more information?**

It is often suggested that the answer to information asymmetry is more information, and regulators have required providers to offer much more extensive descriptions of products and practices. But information asymmetry is found in many markets for complex goods and services, and persists because consumers have neither time nor inclination to seek or absorb more information. Many people who deplore public ignorance in financial services matters would hesitate to open the bonnet of their car, or to distinguish their larynx from their thorax. The consumer is confident in purchasing products such as automobiles or medical services, about which he or she knows little, as a result of the efforts producers invest in developing good reputations with their customers, and because users are able to access the skills of trusted intermediaries.

Producer reputation and reliable intermediation are the mechanisms through which markets handle information asymmetry. If there is a problem in financial services – and there is – it is because producers have had little regard to their long run reputation and because intermediaries have not deserved the trust of consumers. There is wide discussion in the financial services industry of the need to restore trust.



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Such discussion rarely focuses, however, on changes in the structure or behaviour of the industry. The issue is perceived as one of public relations. But the problem is one of substance, not appearance.

It is not appropriate, or realistically possible, for public agencies to prescribe in detail the conditions and methods by which financial services products are sold. Regulation is necessary, supervision is undesirable, and so regulation should work with market forces rather than to supplant them. The principal successes of the financial services regime since 1987 have used this approach. The 'naming and shaming' of major providers for misselling pensions and endowment mortgages has encouraged the firms concerned to protect their reputations by reforms of their internal processes.

Regulators have also enjoyed success in improving the performance of intermediaries, but the process is slow. The general public can be best served, in financial services as in most other product areas, by the presence of effective retailers.

### **Conclusion: building an effective retail market in financial services**

In modern business, good retailers succeed by being sensitive and responsive to the needs of their customers on the one hand, and demanding in the price and quality they expect from their suppliers on the other. Their existence does not eliminate the need for statutory regulation, but it reduces it. In areas such as product safety the vigilance of retailers acts as a powerful supporting control mechanism. To the extent that the farmer's business is supervised, it is supervised by retailers. The efficiency with which such supervision is performed is a key competitive advantage of a good retailer.

Retailing of financial services has been very different. Historically, banks were horrified by the notion that they were retailers at all. As with many other cartelised or monopolised industries – think of the nationalised telephone network – banks treated their customers as applicants for their services. More recently, however, the culture has become sales driven, but undesirably so with widespread misselling and poor value products being cross-sold to existing customers.

Both the dot.com bubble and the sub prime mortgage crisis were the result of giving sales forces substantial incentives to peddle products that were unsuitable for customers but enabled the providers to report substantial, if often illusory, profits.

All retailers survive, of course, from profits on the products they sell. But a strategy of focussing on high price goods because they offer larger retail margins is the opposite of the business model pursued by successful retailers such as WalMart and Tesco. These firms have instead pursued volume growth through competitive pricing, building a sustainable long term relationship with their customers through a justified reputation for value for money. A more competitive market, facilitating new entry, would not only allow but encourage businesses to adopt a similar approach to financial services. It is likely that WalMart and Tesco would be among them.

Regulators have had some success in curbing excesses but viewing the performance of the industry as a whole it is hard to conclude that customers are better treated than they were twenty years ago. As one historic problem is eliminated – the



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misselling of personal pensions – a new one emerges – encouraging households to take on unaffordable debt. The product driven culture is a predictable consequence of vertical integration in the financial services industry.

Indeed the problem goes deeper than vertical integration. It is not in the interests of lending institutions for their customers to take out loans these customers cannot repay. The driving force in the sub prime crisis was the profitability of securitised products for the individuals who sold them, at both wholesale and retail levels.

These instruments were created in investment banks, and the investment banking operations of conglomerate banks: organisations more appropriately regarded as collections of greedy individuals than as corporate organisations with an interest in sustaining the reputation and value of the business. Their transactions oriented culture corrupted the retail sector, whose long run viability depends – as does most retailing – on the development of trust relationships with customers.

It is hard to think of a worse response to this problem than the award of large subsidies to the failed conglomerate institutions responsible, combined with a pretence that similar problems will in future be prevented by a system of supervision dominated by financial services interests. The future health of the financial services industry depends on the creation, or perhaps re-creation, of a customer-focussed retail sector. The assessment of the value of new products is best carried out, as in most of the economy, not by manufacturers or regulators but by competent retailers in close touch with the needs of their customers.

Some of these retailers from other sectors will themselves have a major role to play in the future of the financial services industry – or at least will do so if market forces, rather than political lobbying, is allowed to determine the future shape of financial services. Firms such as Marks and Spencer, Tesco and Sainsbury have made forays into the provision of financial services, but so far they have mostly been content to shelter under the umbrella of the ample margins available on established products. They have not yet been aggressive in either pricing or product development. Supervisory restrictions closely related to established business methods are, and are bound to remain, an obstacle to innovation. These retailers, and businesses like them, are likely purchasers or founders of narrow banks. Other utility retailers, notably mobile phone companies, might also see an opportunity.

In the short run, it is likely that narrow banks would mostly be subsidiaries of financial holding companies. But if retail banking activities were effectively ring-fenced from investment banking, it is probable that traders and investment bankers would lose interest and the subsidiaries would be sold or floated. Their interest in the retail sector is in the money, not the business. Other financial services companies, such as insurers who choose to focus on retail operations, might be potential operators of narrow banks.

It is now apparent that the conversion of the mutual building societies to public limited companies did, in the end, inflict considerable damage on the UK financial services sector. All the large societies which converted either failed or were absorbed into large financial conglomerates. This reduced competition and the institutions which were eliminated had achieved significantly higher levels of customer satisfaction than their listed counterparts.



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The clock cannot be turned back and there is no case for subsidy or artificial protection of mutual or not for profit financial institutions. But there is a strong argument for establishing a legal framework which would prevent the realisation of the assets and goodwill of businesses for the benefit of a single generation of customers. Mutuals would then compete with profit-making companies on the merits of the alternative business models, and would not be destabilised by extraneous factors.

It is sometimes argued that narrow banks would be boring, and would be attractive only to untalented people. 'Retail is detail' is a mantra of shopkeepers. The challenges of financial services retailing are likely to be boring for people whose eyes light up at the description of a CDO squared, the calculation of the value of an exotic derivative, or the prospect of a large corporate acquisition.

But that is the problem. People such as these, talented though they may be, should not be running retail financial services businesses. The people who should be in charge of these businesses are customer focussed. Not at all untalented, they recognise that retail is detail and derive their satisfaction from identifying the needs of their shoppers and meeting these needs more effectively. Many such individuals are already employed in the financial services sector. It is time to give them their opportunity, free of the distorting and – in the last decade, massively disruptive – influence of the deal makers, traders and investment bankers, who dominate financial conglomerates.

Narrow banking is desirable not just because it provides a sounder basis for regulation of the banking industry, important though that issue is. The implementation of narrow banking would provide a catalyst for the restructuring of the financial services industry - a restructuring which would create a sector focussed on innovation and service directed to the needs of its customers.