Corporate diversity in financial services

An updated diversity index

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Building Societies Association

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Introduction

Having a diverse range of providers of financial services has been shown to result in more effective competition for consumers as well as a more stable financial system. The Coalition Government therefore made a commitment in 2010 to foster diversity in financial services and promote mutuals.

Research was published in 2013 into the degree of diversity in the UK's mortgage and savings markets, establishing the Diversity Index, or 'D-index'. This found that the degree of diversity had declined prior to the financial crisis of 2007-08. However, it also found that far from improving since 2010, the degree of diversity had actually deteriorated slightly. This paper updates that research, incorporating data for the latest two years available.

It finds that while the deterioration in diversity had been levelling off, the change in ownership of the Co-operative Bank means that financial services markets are now even less diverse than ever. As a result, competition is not as effective as it could be, and the impact on the financial system from the next crisis could be substantial.

"A key part of the government's long term economic plan is to increase competition and choice in the banking sector so that customers get a better deal. I therefore welcome this study by the BSA and its academic partners into diversity in financial services. This is vitally important for the delivery of good outcomes for consumers and businesses, and for the stability of the financial system."

Andrea Leadsom MP, Economic Secretary to the Treasury

The first Diversity Index

In 2013 the first results of a new approach to measuring the diversity of firms in the UK's mortgage and retail savings markets were published. The research was carried out by academics based at the University of Oxford Centre for Mutual and Employee-owned Business. They constructed the Diversity Index (D-Index) based on four components:

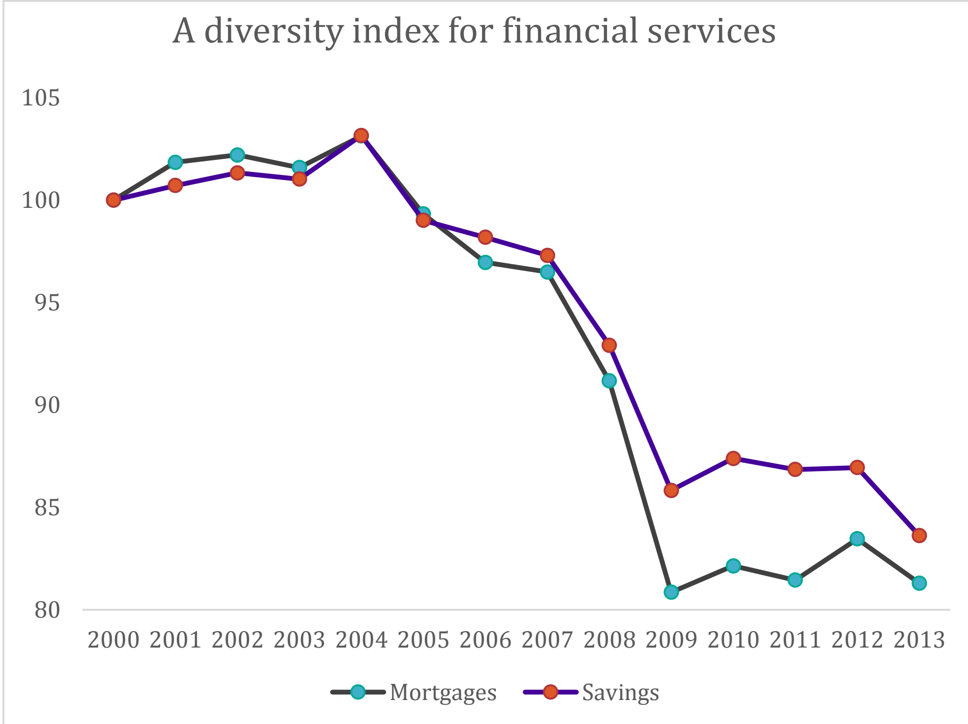
- the size and number of firms in the market
- who they are owned by and run for
- the sources of their funding and resilience
- and where they are located in the UK

The D-Index showed that between 2000-2011 there was a significant shift towards a concentration of larger, shareholder-owned, wholesale-funded, London-centred banks. There had been a general decline in headline diversity from 2004, before a more dramatic reduction in diversity due to the actions taken to protect the financial system at the height of the financial crisis. In both the mortgage and savings markets the D-index then levelled off in 2010 and 2011, more than 15% below their 2004 levels.

Latest results

The Diversity Index has now been updated with results up to 2013. The D-Index remained relatively steady in 2012, but then declined in 2013.

In the savings market the D-index recorded its lowest level since measurement started in 2000, and is now down almost 20% from its 2004 peak. The mortgage D-index also reduced in 2013, falling to its lowest level since 2010. Mortgage market diversity is now also around 20% below its peak level.



"The diversity index for financial services shows that the decline in diversity observed since 2004 continued in 2013 – the latest year for which figures are available. Given the importance of diversity for competition and the stability of the financial services sector, government and regulatory bodies should explore ways to foster diversity as a matter of some urgency." **Professor Christine Oughton, Head of the Department of Financial and Management Studies, SOAS University of London.**

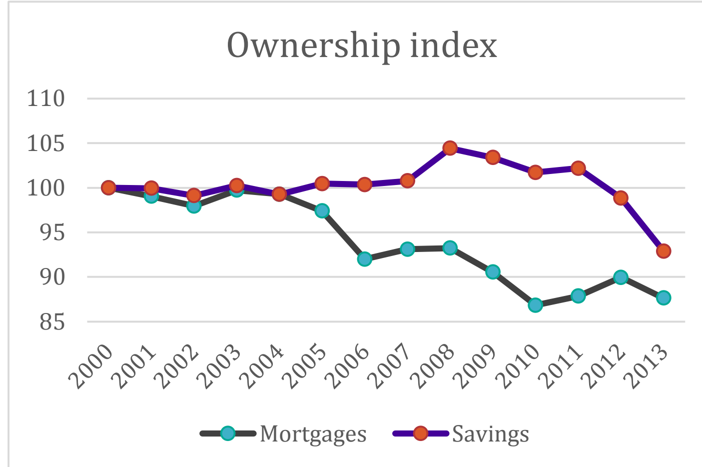
Professor Jonathan Michie, University of Oxford added that, "The latest figures for the Diversity Index demonstrate the importance of monitoring the degree of corporate diversity in the economy. I trust that all the political parties will include a commitment to increasing the corporate diversity of the financial services sector in their manifestos".

Ownership and Corporate Diversity

How diverse is corporate ownership? What proportions of the market are controlled by shareholder-owned companies, customer-owned mutuals or Government-owned institutions?

Diversity in the mortgage market had declined after 2004 as shareholder-owned banks and specialist lenders competed aggressively for business. In the last few years mutual lenders such as building societies have contributed a substantial share of new mortgage lending, while the big banks have restructured their businesses. This caused the ownership diversity index for the mortgage market to recover slightly. In 2013, however, the change in ownership at the Co-operative Bank meant that it moved from the customer-owned sector to the shareholder-owned sector, which caused this trend to reverse, so that corporate ownership diversity in the mortgage market was back at 2011 levels. If the Co-op had not changed sector, the ownership index for the mortgage market would have reached its highest level since 2005.

The diversity of corporate ownership in the savings market had held up better than in the mortgage market, as the big banks drew on wholesale funding sources before the crash. In the crisis, building societies and state-owned NS&I were seen as safe havens for deposits, causing the savings ownership index to rise. This change then reversed in recent years as the crisis abated and banks competed for retail savings to rebalance their funding mix. In 2013, the switch in ownership at the Co-op added significantly to this decline to leave the corporate diversity index 11% lower than it was in 2008.

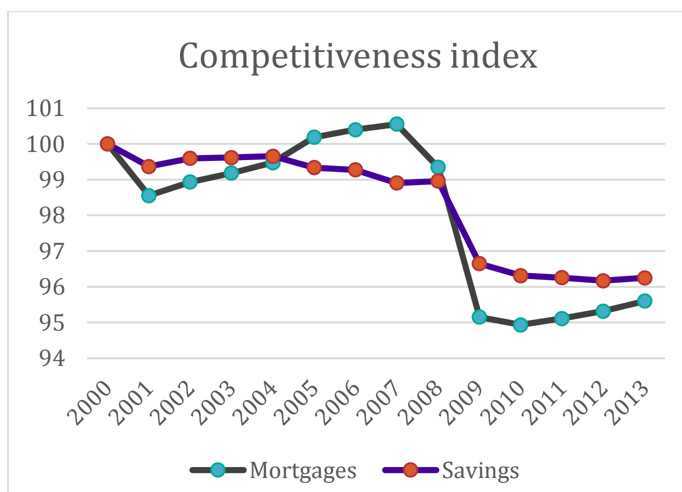


Measurement basis: weighted market shares held by different ownership types

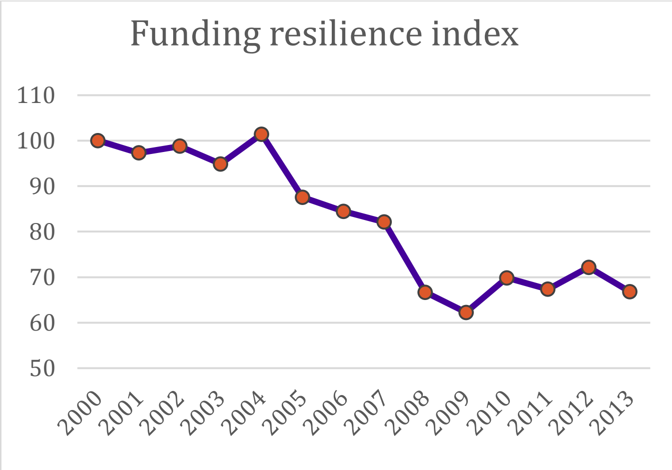
Market concentration

Is the market dominated by a few large firms, or spread between a greater number of small players?

The big changes in market concentration occurred in the financial crisis with the mega merger of Lloyds and Halifax-Bank of Scotland. Since then, in the savings market concentration has remained broadly flat. In contrast, concentration in the mortgage market has reduced gradually as some of the big banks withdrew from the mortgage market and other lenders such as building societies increased their market shares. This has resulted in the mortgage competitiveness index rising to its highest level since the crisis.



Measurement basis: competitiveness measure based on each firm's share of the market



Measurement basis: the proportion of firm's lending funded from retail savings as opposed to wholesale sources

Approach to funding and resilience

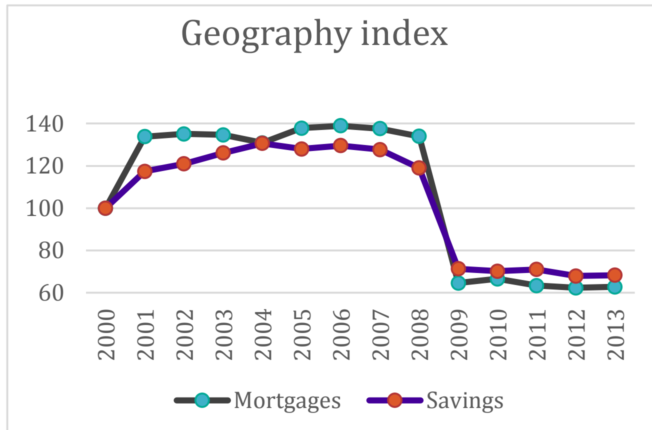
Do firms rely on retail savings for their funding, or do they raise it from other financial institutions on the wholesale markets?

The stability of the financial sector depends partly on the funding models used by financial institutions. The funding or resilience sub-index declined since 2004, suggesting a lower level of funding resilience due to the move towards more wholesale funding, much of which is borrowing from other financial institutions. After the crisis this trend reversed somewhat, but now appears to have stabilised.

Geography

Where are firms located? Are their strategic centres concentrated or spread out across the country?

This component is affected by mergers, with the Lloyds-HBOS merger in 2009 causing a significant fall in the index as the control of financial services became more geographically concentrated in London. Since the crisis these indices have therefore stabilised.



Measurement basis: the distance of each firm's head office from the City of London

Why is it better to have a diverse range of providers?

No single approach to providing financial services has proven to be optimal in all respects at all times. Instead, creating an environment where different firms pursuing different objectives interact yields some important benefits.

Competition is more effective: as firms operate with different incentives and goals, they compete to win and serve customers in different ways. This can spur innovation and greater consumer choice.

The system is more stable: when a shock such as the credit crunch hits, if firms vary, such as in how they raise funding, they are affected in different ways, reducing the risk of the shock spreading across the entire financial system.

Where next for diversity?

Although the diversity index and its four sub-indices show that we are in a worse position compared to a decade ago, the level of diversity had been steady in recent years until the changes required at the Co-operative Bank led to a further decline.

Events at the Co-op demonstrate once again that there is no single organisation that is immune from problems, so there is likely to be value in allowing different approaches to exist alongside each other.

This event also detracts from a slight improvement in diversity in the mortgage market in recent years as some large banks have lost market share to other lenders, such as building societies.

New challengers have entered the market, but are yet to grow their scale to have real impact. Other changes that could support diversity in the years ahead will be the divestments Lloyds and RBS are required to make.

What needs to happen now?

What is required to support diversity in financial services provision is an environment where all types of firms are able to operate on a fair basis, with regulations that are appropriate to them rather than being a single approach for all.

The benefits of having different approaches to service provision should be better reflected in the way that policies and regulations are made, rather than treated as an aberration. Too often policy has been determined for large, plc banking groups and has therefore been inappropriate or unnecessarily burdensome for smaller firms or organisations with different ownership structures, or for new entrants. Regulation that pushes towards uniformity can prevent new challengers who might be looking to apply new technologies to the market, and old challengers, such as building societies, from following a different tack to the large incumbent banks.

We have seen some helpful steps towards a more enlightened approach, such as the Government's recognition that existing building society legislation broadly fulfilled the role of ring-fencing, avoiding unnecessary regulatory duplication. More broadly, when regulators introduce new policy they are now required to assess the impact on competition, including on different types of firms. This approach is welcome, but needs to be integrated into the policy making process, rather than an add-on to the end of the process. The BSA believes that financial regulators should be given a statutory duty to promote diversity.

Reference documents

1. Coalition partnership agreement, Cabinet Office, 2010
2. A diversity index for financial services, BSA 2013
3. Measuring Diversity in Financial Services Markets: A Diversity Index, Michie, J. and Oughton, C. 2013, Centre for Financial and Management Studies Discussion Paper No. 113, SOAS University of London, downloadable from http://www.cefims.ac.uk/cgi-bin/research.cgi

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