APPG on Challenger Banks and Building Societies
Response to Call for Evidence

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We provide responses below to some of the questions the APPG is seeking to understand. Our responses are supported by more detailed evidence provided in attachments. We are happy to elaborate further to the APPG.

Is regulation proportionate to encourage a diverse range of institutions?

- *Why is diversity of institutions a good thing?*

Diversity in financial markets is beneficial for 3 main reasons.

1. Effective competition depends not only on the *number* of financial institutions and their market shares; it also depends on the *type* of financial institutions and their corporate objectives. Different types of financial institution behave differently. Some operate more closely in their customers' interests, while others are more driven by the needs of outside shareholders. Shareholder-owned banks aim to maximise shareholder value and returns to shareholders (sometimes at the expense of customers). In contrast, mutually owned banks (mutuals) are customer owned and aim to maximise the welfare of their customers. Government owned National Savings and Investment (NS&I) aims to encourage saving. Providing savers and borrowers with choice in the *type* of providers is important: effective competition depends on the *type* of competition as well as the *number* of competitors. Our research and that of others (e.g. Heffernan, 2005[1]) shows that building societies generally offer consumers better rates.
2. Different financial institutions follow different balance sheet strategies with diverse funding models and attitudes to risk. Such diversity can be functional in that it promotes financial stability. In the run-up to the financial crisis Banks' balance street strategies became more homogenous and interconnected. When the credit crunch hit, a large number of institutions were affected by the same risk at the same time resulting in fragility and instability (Haldane and May, 2011[2], Michie and Oughton, 2013). Diversity in balance sheet strategies and funding models underscores stability by reducing the risk of a shock spreading across the entire system.
3. Financial institutions play an important role in the growth of cities and regions. Tailoring corporate strategy to the diverse needs of localities and regions is key to ensuring that the needs of different customer bases are fulfilled. Financial institutions are more likely to take account of local and regional needs when their strategic decision-making headquarters is located in, or close to those markets.

[1] Heffernan S. (2005) The Effect of UK Building Society Conversion on Pricing Behaviour, *Journal of Banking and Finance*, 29:3:779-797.

[2] Haldane, A. G. and May, R. M. (2011) Systemic risk in banking ecosystems, *Nature*, Volume 469, 20 January, pp. 351-355.

- *Is there a conflict between the requirements for financial stability and consumer protection?*

There need be no conflict; promoting diversity in financial services can enhance stability and raise consumer welfare by providing more effective competition. Our research shows that greater diversity promotes consumer welfare by providing consumers with more competitive mortgage rates and better savings rates. Research has also shown that more diverse financial systems are more stable.

- *Are regulators doing enough to encourage diversity?*

We have constructed a measure of diversity in financial services in the UK mortgage and deposits markets. Our analysis shows that diversity has fallen on trend and that while there has been a marginal recovery in the past 3 years, diversity in financial services is still well below its 2000 level and below that of a number of other G7 countries. Over the past 18 years diversity has fallen and relatively little has been achieved in terms of promoting diversity.

Is there effective competition and is there potential for new market entrants?

- *Is there effective competition?*

We find that effective competition depends not just on the number of financial institutions and their market shares, but also on the extent of diversity amongst financial institutions.

Diversity in financial services has fallen significantly reducing the degree of effective competition in financial services. There is, therefore, potential to increase diversity and effective competition by returning diversity to previous levels.

The impact of new market entrants will depend on their type. Competition from some types of new entrants e.g. the rise of non-specialist lenders (such as Lehman Bros) in the run up to the financial crisis can be transient and damaging. Policies to promote competition should promote different types of banks, including mutuals, and not just more banks.

Why are there so few retail banks in the UK compared to other countries?

The UK financial services sector is more concentrated than that of most other G7 countries, it is also less diverse than in Germany, France and Japan. Evidence is provided on G7 countries in the NEF Resilience Index report (attached).

Market structure is partly a response to past regulatory decisions e.g. part of the loss of diversity in the UK can be traced to the decision to allow building societies to convert to Plc banks, while high levels of concentration are partly the result of the use of mergers to resolve financial failure.

Further information is provided in the following supporting evidence:

Michie, J and Oughton, C (2013) Measuring Diversity in Financial Services Markets: A Diversity Index, *Centre for Financial and Management Studies Discussion Paper No. 113, April, CeFiMS, SOAS, University of London*.

Michie, J and Oughton, C (2018) Diversity Index 2018, Update.

NEF (2015) Financial System Resilience Index*, NEF May, 2015, London.* Michie and Oughton were consultants to this project/report.

Presentation on *Diversity and Mixed Oligopoly* in Financial Services by Michie and Oughton.

Presentation on Diversity, Resilience and Stability in Financial Systems: joining the Twin Peaks, Presentation to South African Reserve Bank Financial Stability Conference 2017 by Oughton.