Getting bank competition right post-crisis

As the battle to contain the financial crisis winds down, the eagerness to return to more normal business conditions is palpable. But it is not just banks that yearn to put the crisis behind them. Bank regulators, too, are eager to pick up where they left off.

For most of the past two decades, the predominant objective of regulatory action in the UK has been to spur competition and deliver value for bank customers. Now regulators want to refocus their energies on that goal, partly because through bank closures, government takeovers and forced mergers, concentration in the banking sector has increased significantly. The six biggest banks have increased their total holdings of retail deposits from 66 per cent to 77 per cent, raised their share of personal current accounts from 85 per cent to 91 per cent, and lifted the proportion of residential mortgages they underwrite from 64 per cent to 78 per cent.

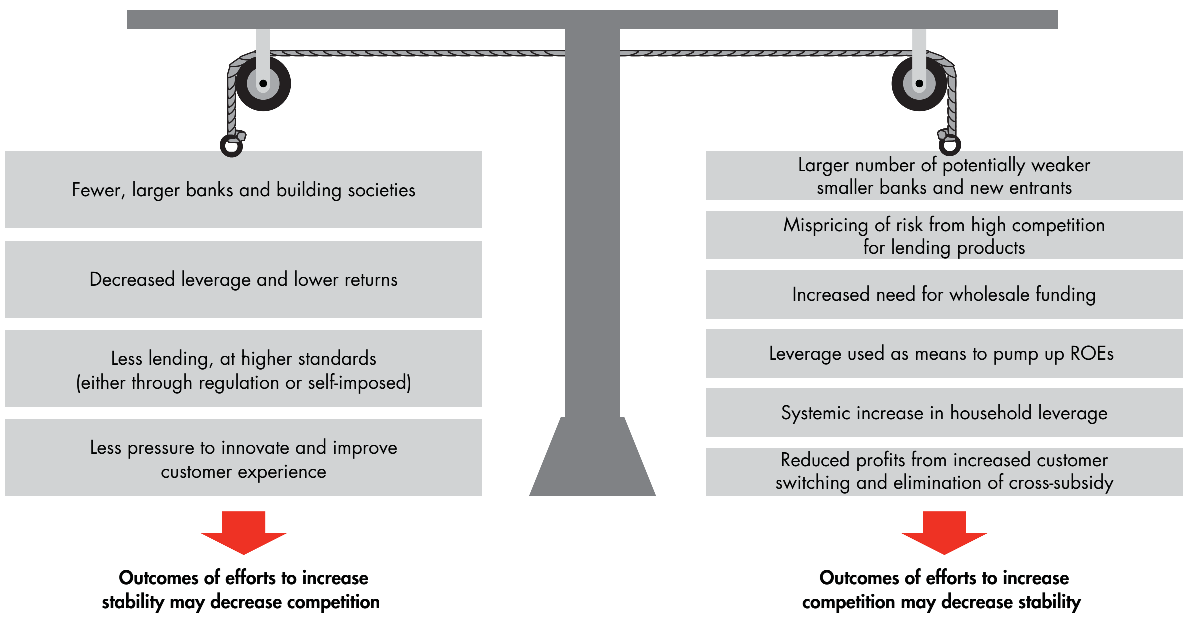
Continued consolidation, regulators worry, can disadvantage savers and borrowers and leave taxpayers on the hook to bail out banks that grow too big to fail. But how regulators go about balancing stability and competition will have major implications for banks, their customers and the broader British public.

Earlier this year, the government charged the Independent Commission on Banking with the job of threading the needle between minimising systemic risk and promoting competition. As the Commission itself acknowledges in an Issues Paper it released in late September that lays out reform options it is weighing, these are challenging objectives to reconcile. Measures that aim to increase stability could result in fewer large banks. Credit may become less available to borrowers as banks shrink their assets to reduce leverage and shore up their capital base. In the end, the pursuit of stability could cause banks to feel less pressure to innovate and improve the customer experience.

But policies that promote competition by encouraging new entrants and even splitting up the big banks could compromise stability, leading to smaller and even weaker banks. As competition intensifies, history says that banks are more likely to misprice risk and increase their need for wholesale funding. They will also be disposed to rely on leverage to boost returns on equity (see Figure 1).

In our view, simple economics dictates that regulators, to the extent that a choice needs to be made, should focus on measures that reinforce stability. Bain & Company calculates that the cost borne by taxpayers from an unstable banking industry is more than

Figure 1: The objectives of competition and stability may have a built-in tension



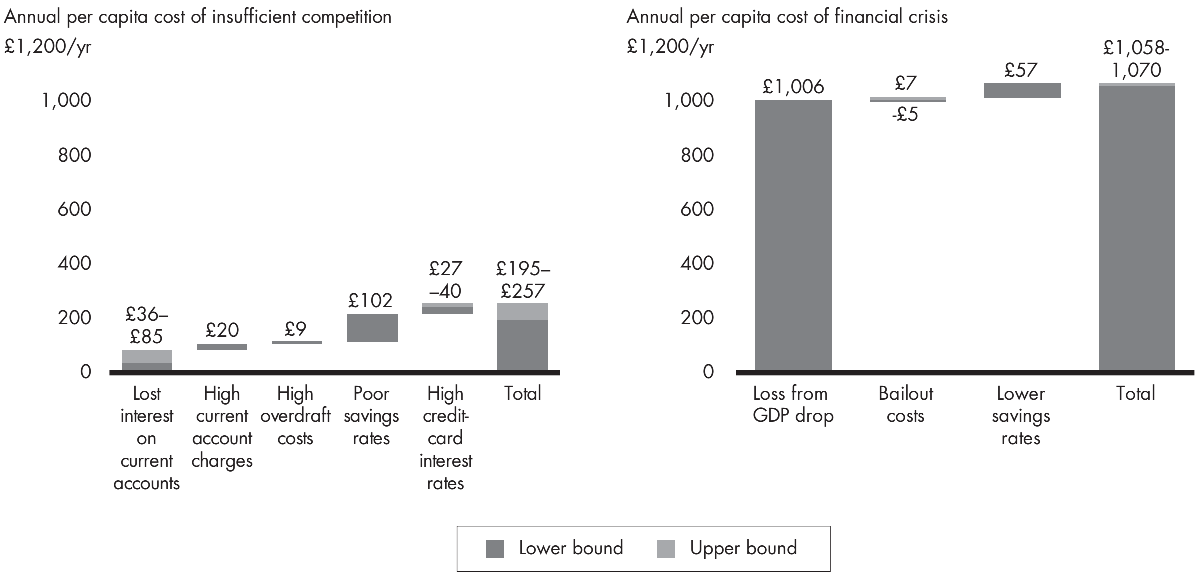
£1,000 per annum per head—mainly as a result of reduced output and higher unemployment. By contrast, regulators inclined to view the UK banking market as insufficiently competitive would be hard pressed to identify the cost of this to customers as more than £200 per annum per head. Those taxpayers and customers are, broadly speaking, one and the same (see Figure 2).

The good news, however, is that it is possible to have both stability and competition without adding large numbers of players and fragmenting the market. Analysing banking markets in 30 countries, we discovered that the most stable outcome that best serves consumers is to foster competition among a smaller number of diversified banks, and that the incremental benefits to consumers from increasing the number of leading players diminish rapidly.

The experience of Australia and Canada, both countries that weathered the global banking crisis without having to resort to government-financed bank rescues, is relevant to the UK. Both have concentrated banking markets that are closely monitored by regulators to ensure that banks meet adequate capital standards, maintain healthy reserves and steer clear of risky activity. Yet banks in both markets earn customer loyalty scores that equal or exceed those in the UK. In Canada particularly, banks have achieved profit growth by focusing on customer service and improving the customer experience.

Whichever course UK regulators choose, banks cannot afford to relent on competing aggressively to win more business from their customers. UK consumers are not willing to park their funds with just one bank, but make active financial product choices across a wide range of providers. Today the foundation for sustainable future growth is shifting to customer loyalty, higher customer-retention rates, relationship-based pricing and a richer customer experience.

Figure 2: The costs of instability are about four times those of suboptimal competition



Source: Bain proprietary data model

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