Building Societies Association

A diversity index for financial services

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A market that has a diverse range of financial service providers results in wider choice for consumers and a more stable financial system, as firms go about providing their services in different ways. Here we describe new research that attempts to measure the diversity of the UK mortgage and savings markets in terms of firm size, ownership, geography and approach, in order to assess the progress the Government makes against its commitment to increase diversity in financial services in the future.

Why is diversity beneficial?

If a single organisational structure was able to deliver everything that society requires from a retail financial services provider, there would be no case for diversity. However, we have not yet found a model which is superior in all respects to others. Instead research has shown that, rather than favouring any particular model in financial services markets, allowing a diverse range of firms to provide financial services can have some important benefits[2]:

– it increases the effectiveness of competition: as firms operate with different incentives and goals, they compete to win and serve customers in different ways. This can improve consumer choice and innovation.

– it helps the system as a whole to be more resilient: when a shock such as the global financial crisis hits, if firms have different approaches, for example to raising funds, they are affected in different ways, reducing the risk of the shock spreading across the entire financial system.

[1] For a full description of the methodology and results see "Measuring Diversity in Financial Services Markets: A Diversity Index", Michie, J, and Oughton, C, Centre for Financial and Management Studies Discussion Paper Series, CeFiMS, University of London, downloadable from **www.cefims.ac.uk/cgi-bin/research.cgi**

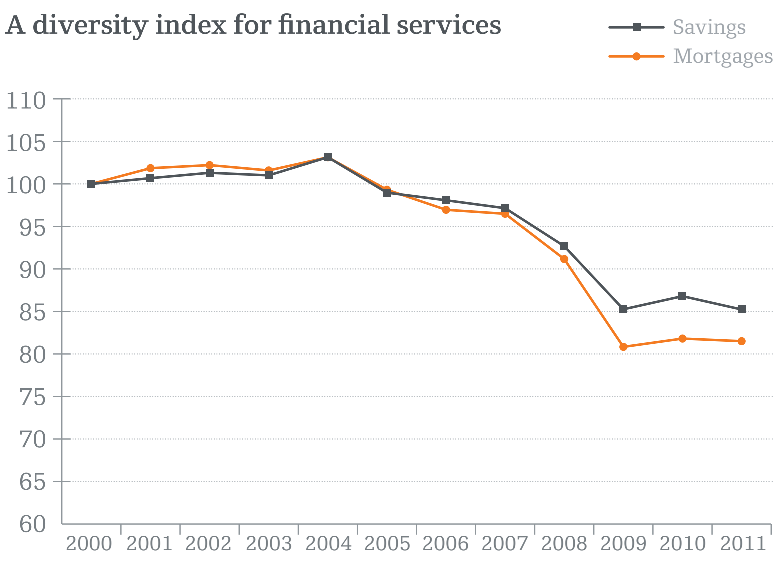
[2] See for example, A Haldane, "Rethinking the Financial Network" Bank of England, 2009

The UK Government committed in the 2010 Coalition programme for government to bring forward proposals 'to foster diversity in financial services, promote mutuals and create a more competitive banking industry', recognising the value in having a diverse range of providers.

The Building Societies Association commissioned academics at the Oxford University Centre for Mutual and Employee-owned Business to develop a measure of diversity so that changes could be gauged and to provide a helpful indicator for current Government policy objectives.

The research, which has just been published, looks at diversity in the savings and mortgage markets in terms of the size of the firms providing these services, who owns them, how they raise the funds they lend, and where they are located in the UK.

If the Government is to fulfil its commitment to foster diversity it will need to do more to ensure that a variety of organisations are able to operate in financial services markets in the future, with the aim of reversing the decline in diversity in the mortgage and savings markets since 2004.[1]



How has diversity changed in the UK mortgage and savings markets?

The results, summarised in the chart above, show how diversity in both the mortgage and savings markets has declined from 2004, prior to the financial crisis.

The unprecedented steps taken at the height of the crisis in 2007-8 to protect the financial system then resulted in a substantial further reduction in diversity. The components of the diversity index are described on the next pages, and show that in the period from 2004 to 2009 there was a general shift towards a concentration of larger, wholesale-funded, London-centric plc banks.

In recent years diversity has stabilised, but at a much lower level than before the financial crisis. In 2011 the index for mortgage provision was 82, and for savings it registered 85, both down from 100 in the year 2000. Consumers are likely to benefit from less competition than a decade ago, and if another crisis were to hit, the system is now more vulnerable than it was.

Promoting diversity

The research shows that valuable diversity in financial services markets reduced as retail financial service providers became more alike.

Although it has stabilised since the Coalition made its commitment in 2010, diversity as measured by the index remains about 20% down on the level observed in 2004. If the Government is to fulfil its commitment to foster diversity it will need to do more to ensure that a variety of organisations are able to operate in financial services markets in the future, with the aim of reversing the decline in diversity in the mortgage and savings markets since 2004.

Some helpful developments are now happening that might help to reverse this reduction. For example, the member-owned Co-operative Banking Group has been granted preferred bidder status in the purchase of branches from Lloyds Bank, technological advancements have opened opportunities for new providers such as peer-to-peer lenders, and the newly formed regulatory bodies, the Financial Conduct Authority and the Prudential Regulatory Authority, are required to consider in any consultation on new policy the impact on mutually-owned organisations.

The Government should continue in this vein and aim to create conditions where different providers with varying business models, locations and approaches can more easily enter and compete on a fair basis. The Government must ensure that policies don't unintentionally distort competition in favour of one approach over another.

This should mean, for example, that building societies are not unfairly constrained relative to ring-fenced banks when those reforms are implemented. Other opportunities to re-mutualise parts of the banking sector should be fully explored. It also means considering how policy choices, such as how to fund the UK's deposit insurance scheme, could have differential effects depending on the types of business in the market, and whether these effects are desirable.

The Government has said it wishes to promote the diversity of provision of financial services. This report is the first step in assessing progress against that goal.

Diversity factors: the component parts of the diversity index

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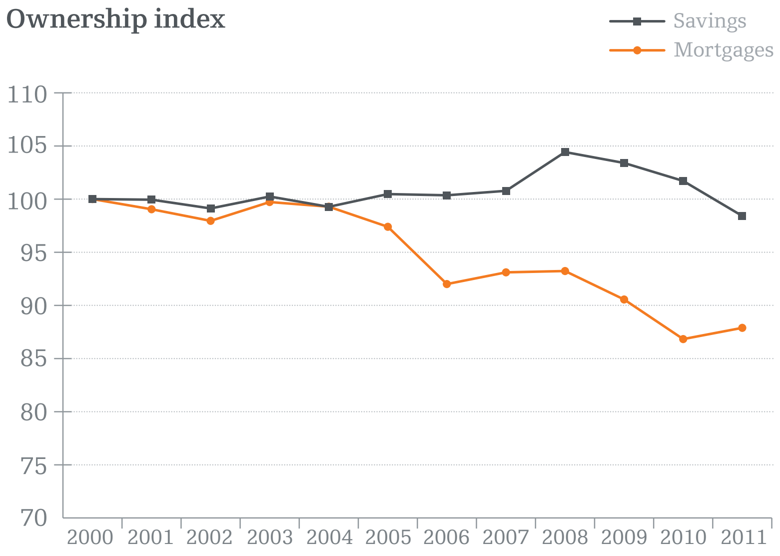
Ownership

How diverse is corporate ownership? What proportion of market activity is controlled by companies owned by private shareholders, by mutuals owned by their customers, or by the State?

In the mortgage market the ownership index has declined significantly, particularly after 2004 when specialist lending companies entered the market and some banks expanded their market share aggressively, so that privately owned banks accounted for a larger share of the market. In contrast, in the retail savings market mutuals have maintained their share as other lenders relied more on wholesale funding markets. And when the crisis hit, savers considered that mutual deposit takers and the State-owned NS&I were safer than some of the banks that ran into trouble. This resulted in Ownership diversity being maintained and then increasing during the crisis, though this change has since reversed.



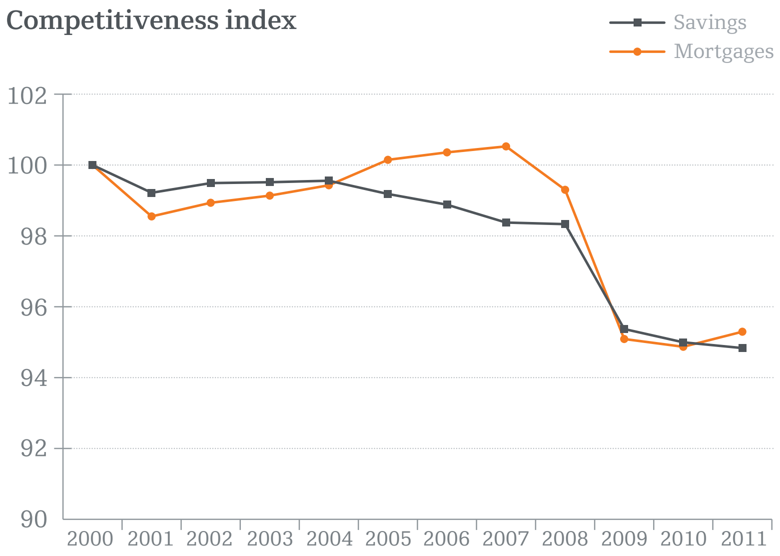
Measurement basis: ownership diversification - weighted market shares held by different ownership types.

Firm size

Is the market dominated by a few large firms, or balanced between a greater number of smaller ones?

In the mortgage market there was a steady increase in competitiveness on this measure from 2001 to 2007 as new specialist lenders entered the market. However, with the credit crunch some of these lenders left the market and large mergers such as Lloyds-HBOS in 2009 increased concentration, reducing diversity considerably after the crisis.

Looking at retail savings, steady consolidation saw competition decrease gradually. Again, actions to force together troubled institutions in the crisis led to a step-change in concentration. In the savings market competitiveness in terms of size of firms has decreased further in the years since.



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

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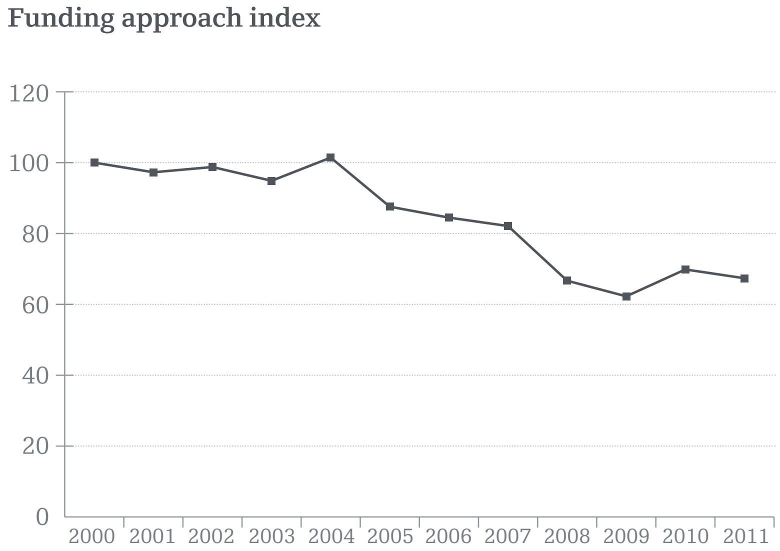


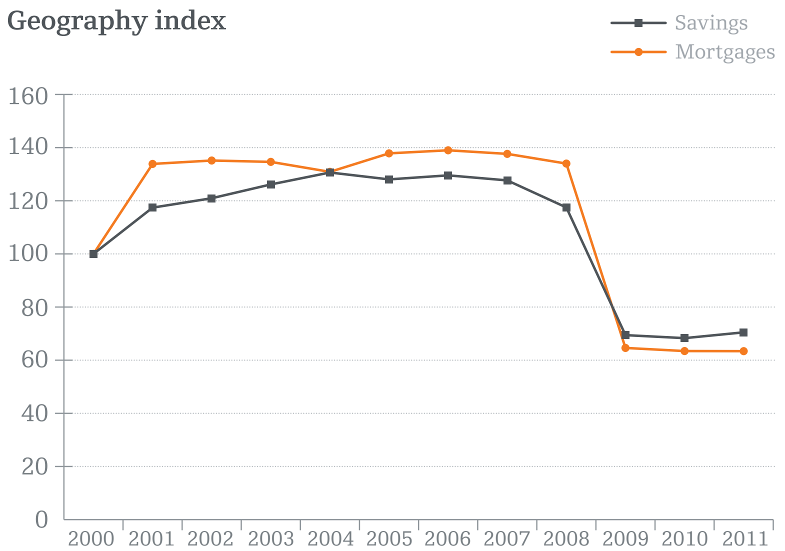
Measurement basis: the proportion of each firm's lending funded from retail savings as opposed to wholesale sources and the inverse funding gap.

Approach to funding

To what extent do firms rely on funding raised from wholesale money markets, rather than more stable retail savings?

The index of funding resilience declined steadily after 2004 before stabilising in the last few years. This reflects that funding models in the retail financial services sector became more concentrated on wholesale funding, particularly at larger organisations, making the system as a whole less resilient to funding shocks. The increased use of wholesale funding, much of which is borrowing from other banks, also highlights the increase in the inter-connectedness of the system.

Recently the decline in the index has been checked as institutions have sought to rebalance their funding back to a greater reliance on retail savings.



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

Geography

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

The geography index shows that the head offices of financial institutions are less geographically spread than they were in 2000. However, there are significant swings in the index over the period. These reflect mergers of large banks: an increase in 2001 when Halifax merged with Bank of Scotland and became the newly formed HBOS, based in Edinburgh, then in 2009 during the crisis when HBOS Group joined Lloyds Bank, based in London, and strategic control shifted to London causing the index to fall.