

A photograph of a university campus with a modern glass building, green lawns, and trees, partially obscured by a large, light blue, curved graphic element on the right side of the slide.

# **Competition in recession: What are the implications for competition in the financial sector?**

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# Tensions

- Co-insurance effects v competition
- High profitability implied by re-building bank balance sheets v lower spreads
- Regulation and lending restrictions v consumer choice
- Arguments for economy, diversification and integrated service in the integrated banking model v risk and possibility of poor consumer outcomes

# Co-insurance v competition

- Argument seems to be that organised combinations lead to co-insurance and reduced need for bail-outs etc
- However, effects can be perverse – e.g. Lloyds-HBOS
- Also reinforces the “too big to fail” problem
- A radical but pro-competitive solution – nationalise failing big banks, create smaller “good banks” and re-privatise
- In future, smaller banks can benefit from deposit insurance but not be too big to fail
- i.e. the consumer is protected but equity holders and bond holders are not insured against consequences of managerial actions

# Re-building balance sheets

- Clearly write-offs show banks were not as profitable as previously thought
- Spreads, arrangement fees, early re-payment fees and non take-up fees have all increased
- But hard to argue that bygones (past write-offs) justify less competition and excess profits going forward
- Whilst re-capitalisation is clearly needed, this will be damaging if earned by excessive profitability from survivors

# Regulation v consumer choice

- Past competition has clearly led to excesses:
  - >100% mortgages
  - self-certification
  - excessive multiples of income
  - “covenant light” PE loans
- Clear role for regulation here, in:
  - Setting far more sophisticated capital adequacy limits
  - Possibly setting maxima for consumer credit?
- In a world of rational markets and rational borrowers, latter could be argued to be anti-competitive, but lenders competing on criteria has undesirable consequences – less competition here could be optimal

# The integrated banking model

- There are *two* arguments here
  - Should retail and investment banking be combined?
  - Do integrated *investment* banks serve the consumer?
- Clearly there are benefits to consumers (corporate and individual) to an integrated model
- And clearly separation of retail & investment banking does not prevent problems
- Turner identifies banks such as NR and B&B as too dependent on securitisation and inter-bank funding

# The integrated banking model (2)

- However, integrated banks enjoy deposit insurance, which might be viewed as distorting competition compared to “pure” investment banks
- Furthermore, combinations more likely to be “too interconnected” to fail
- But we might also ask whether even integrated investment banks serve the consumer well
  - Lack of genuinely independent research (e.g. Spitzer)
  - Co-ordination between analysts, market-makers and corporate finance (do “Chinese Walls” really work?)
  - Might separation of these three functions be pro-competitive?
- Proper market mechanisms (standard contracts and clearing houses) for significant financial instruments could remove counter-party risk compared to unregulated OTC markets

# Conclusion

- Economic efficiency needs a competitive banking industry lending at fair margins – particularly important for smaller firms without access to corporate bond market
- Unlikely to be realised in a world of a few large merged “zombie” banks trying to re-build their balance sheets
- One solution is nationalisation and creation of “good” banks
- Also important in future to get away from the moral hazard that goes with the “too big” or “too inter-connected” to fail banking model
- Can make a case for a banking industry of more smaller banks, banks separated by function, and organised markets for significant financial products
- In general, implies more competition, not less – though arguably less competition in relaxing credit criteria