BREAKING UP *is hard* TO DO

A political plan on the radar to increase competition in retail banking by splitting up the UK's large banks would be doomed to failure. DR ROB WEBB argues the case.

Banks are different. This is the message we've been hearing for many years, stretching way back before the catastrophe of 2008. But why banks are different needs to be examined to understand why any plan to increase competition in retail banking by splitting up the UK's large banks would be doomed to failure. >>

On the one hand, it's a fair argument. After all, not many people today would argue: "Competition is bad. Let's create a monopoly – that'll work." Yet therein lies the problem: very few people understand banking. If more politicians and more of the population understood bank operations, what they do, how they do it and how it helps the economy then we would be better placed to make informed and beneficial changes.

Retail banks take on risk and, unlike the majority of companies in the UK economy, manage risk for profit. There's no doubt, too, that large retail banks are in a unique and privileged position in the economy. Hierarchically, they sit just below the Bank of England, with other financial institutions another rung down. This allows them to operate differently to other financial institutions, ostensibly creating credit – a feat that many, especially in the US, have referred to as alchemy but which is certainly a neat trick when not abused.

Banks create loans, which become spendable deposits. These are multiples of the original cash deposited. Large UK banks held less than 0.4 per cent as cash assets in 2004 and 2005; in post-crisis 2009 they held 10 per cent. They can do this because of economies of scale. Having more branches, being high up in the hierarchy and facing low competition enables outflows and inflows of cash to be calculated with more certainty and less risk. Large banks are assured that most of the money in circulation will be maintained among themselves. Less competition, more certainty, more loans generated and more economic growth: Western economies have grown strong on such a process.

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Economies of scale are everywhere in banking – not least in lending. This creates ever-higher barriers to entry. Even in today's market you need a whole infrastructure of branches, loan offices, risk analysts and IT to assess the information each loan application generates. Economies also emanate from the demand side. Bank services are difficult to evaluate for customers, who instead tend to rely on reputation and non-price elements such as customer care or condition of the bank branch. Few are able to gauge the entire operations of a bank to assess its chances of going bust. People equate "large" with "stability" and "confidence". The result is apathy and free-riding. Statistics show very few people switch banks in their lifetime: for example, Office of Fair Trading figures estimated just 6 per cent of bank customers switched accounts in 2008.

The individual dynamics of competition in lending are also unusual. In most competitive industries, a purchasing customer would scan the internet, go down the high street and check all the prices before making a decision. To be offered a loan in the retail lending market you must fill in the required lending form and wait for checks and balances to be made to ascertain whether you're a "good" or "bad"

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person to whom to lend, which not only takes time but also affects your credit rating – make lots of loan applications and your credit rating goes down. In the SME lending market, banks use very similar lending modules and assess risk in similar ways. This does lead to the inevitable, whereby if one bank says no then they probably all will.

Given all these elements, it's difficult to see how setting limits on bank domination and then breaking up the large retail banks would help the situation. Are we even sure we want banks to compete aggressively for loans? A greater number of equal-size banks is likely to see funding costs go up (as risk of failure goes up), and any undercutting of the risk premium would increase both lending risk and systematic risk. Crucially, bank crises tend to be created by myopia and bankers ignoring the basic rules of banking (and bank lending) *in the face* of competition rather than due to a *lack* of competition.

What we essentially have is a sort of natural oligopoly. Even in today's market – where the importance of the branch has declined, staffing levels have fallen, the internet has transformed the landscape and complex instruments are increasingly used to both source funding and manage risk – costs of entry remain high and chances of success remain low. See Northern Rock for an extreme example.

It's also plain that those entering the retail banking market post-crisis bear a remarkable resemblance to the banks already in the sector. The result is that they don't provide a radical alternative to the established norm, and creating equal-size clones of what we already have won't change that.

In the large banking market we would be much better advised to monitor bank behaviour and set sensible regulations that aim to restrict bank excesses, especially in lending. One way to start would be to increase the transparency of bank balance sheets and oversee holdings of financial assets, which would prevent banks from over-expanding into what they consider profitable "new" openings such as sovereign debt or asset-backed security markets. This is what Basel III is attempting to achieve by establishing more rigorous capital standards directly linked to the risk of assets held by banks.

Ultimately, the real danger of splitting up the UK's large banks is that it may well serve only to increase risk, raise loan rates and destabilise the system. What would most likely happen is that those banks that ride out the resulting storm acquire the others – and we'll be right back where we started. By way of evidence, remember that most of the important building societies that demutualised are now in the hands of the big players. The fact is that banks *are* different; any plan to break up the big banks is merely a muddled recipe for more of the same.

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