

# [Industry report on the united kingdom banking and finance industry](https://assignbuster.com/industry-report-on-the-united-kingdom-banking-and-finance-industry/)

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1. Industry overview

In 2018, the financial services sector in the UK contributed £132 billion to the UK economy, that is 6. 9% of total economic output, with 49% of output generated in London. (financial services, 2019) Furthermore, the UK finance and banking industry hosts 1. 1 million financial services jobs; 3. 1% of all jobs. UK exports of financial services were worth £60 billion in 2017, while imports were worth £15 billion, therefore we can observe that the Finance and banking industry has a surplus of £44 billion.

Measures of the financial and banking sector usually include activities of a wide range, these include retail banks, building societies, investment banks and hedge funds. However, for the focus of this report I will take a narrower view, focusing on the leading banks, this is so points can be correctly analysed in detail rather than on a wide spectrum.

The UK financial services industry is operated by very few large firms, these companies are as follows:

* Barclays
* HSBC
* Lloyds banking group
* RBS
* Bank of England
* Standard chartered

2. Market structure:

As a result it is clear that the UK finance and banking industry, is clearly oligopolistic.
In order for a firm to be oligopolistic it must have a few large firms, they are usually differentiated and heavily advertised products, varying barriers to entry and, choice over prices, inevitably with interdependence leading to price stability.

Micheal J Mazzeo States that “ Each individual firms product choice affects its own profitability, and the extent of product differentiation influences the intensity of competition for all market participants” Mazzeo, M. (2002). In analysis we can recognise that similarly the UK banking and finance industry can be viewed as competitive, due to the above point of the wide range of financial activities in the industry, including investment banking to hedge funds. Furthermore, supporting the point that the industry is in fact oligopolistic. In contrast it can be examined that an oligopolistic market creates a downward sloping demand curve, with relatively inelastic pricing.

At this point it is clear that the market leader in the industry is HSBC, with the highest market capitalisation of 149. 7 billion dollars, therefore we can identify HSBC as the price maker of the industry, and the remaining firms price takers, resulting in market wide price interdependence, ultimately leading to price stability. It can be observed that the UK banking a finance industry supports the theory of collusive oligopolies.
Collusion can be defined as “ Oligopolists agree, formally or informally, to limit competition between themselves” this can be observed through price fixing, quotas, and the limitations of advertising. However, on the other hand, it can also be recognised that the UK banking and finance industry also holds symptoms of tacit collusion, specifically the leader – follower model.

3. Collusion:

Tacit collusion can be defined as “ a situation where firms have an unspoken agreement to engage in joint strategy” Typically within tacit collusion the price is set by the largest firm, in this case HSBC. Additionally, tacit collusion can also host barometric price leadership, in which the price is set by the most ‘ reliable’ firm; the one with the best barometer of the market conditions. There are several factors contributing to collusion in a market, for example, very few firms, all known to each other, they are open about costs and production methods, they have similar production methods and transaction costs. Conclusively each of these points can be used to describe the UK banking and finance industry, therefore supporting the point that the industry follows the leader-follower system of tacit collusion.

Another example of collusion between the largest banks happened on the 16th May 2019, 5 of the largest banks in the United Kingdom were fined more than €1bn (£875m) by the European Union for rigging the multitrillion-dollar foreign exchange market. The European commission stated that the banks, which include Barclays and RBS, formed two cartels to manipulate the spot foreign exchange market for 11 currencies, including the US dollar, the euro and the pound. Makortoff, K. (2019)

As a result, we can recognise the severity of collusion within the UK banking and financial industry, not only is there evidence of tacit collusion but also the formation of cartels.

4. Concentration analysis:

An industries concentration relates to the competitiveness of the industry; concentration is measured as a percentage from 0% - 100%. Seller concentration is one of the most widely used indicators of market structure and examined by the number and size distribution of buyers and sellers. The importance of size distribution as an industry with no identically sized firms has different competitive conditions compared to an industry with one dominant firm and 9 smaller followers, hence why sellers concentration often is perceived as an indication of competition intensity.

Concentration is determined by dividing the market share of the leading firms by the entire market size, then multiplying the result by 100% to form a percentage. In this case, as we are using a narrower outlook, therefore the market will consist of the 6 biggest firms.

Therefore we can observe that the 6 leading firms by market capitalisation are:
1st – HSBC – 149. 7 billion dollars
2nd – Lloyds banking group – 52. 8 billion dollars
3rd – Barclays – 37. 8 billion dollars
4th – RBS – 35. 1 billion dollars
5th – Standard chartered – 28. 6 billion dollars
6th Virgin Money – 2. 6 billion dollars

Market size of the leading firms: 306. 6 billion dollars

Next we need to add the market share of the four largest firms together:
149. 7+52. 8+37. 8+35. 1 = 275. 4 billion dollars

Then we divide our market share of the leading four firms by the total market size:
275. 4/306. 6 = 0. 898 X 100 (to give us a percentage) = 89. 82%

As a result of this analysis we can recognise the fact that the UK banking and finance sector is in fact a very oligopolistic market. This is due to the fact that these sums translate into how much of the market is run and owned by the top four firms, and for an oligopoly to exist very few firms must hold the majority of the market power. In contrast it can be argued that due to the leading four firms dividing 89. 82% of the total market, there is a severe decrease of competitiveness within the market, this can be examined using the large numbers of barriers to entry that exist within oligopolies.

Using the structure-conduct-performance paradigm we can recognise that only efficient firms will survive in a market with high concentration, this is because large firms exploit economies of scale to gain market power within oligopolies, eventually leading to interdependence of firms on each other within the market. Therefore, firms that produce inefficiently in the market may have to withdraw as competition intensifies. This is especially true for the UK banking and finance industry, there is such vast interdependence of the leading four firms in the market that the smaller less efficient firms cannot keep up.

5. Barriers to entry

Tacit collusion within oligopolies defer smaller firms from entering the market, within the UK banking and finance industry tacit collusion defers smaller firms from entering the market because the price is set by the biggest firm, HSBC, using dominant price leadership, this acts as a strong barrier to entry due to the fact that the price is set to a point in which only the biggest firms can afford.

Further barriers to entry in financial markets can occur due to licensure laws, capital requirements, access to financing, regulatory compliance and security concerns. For example, the introduction of E-banking, which produces increasing fees that start-ups will struggle to afford. Furthermore, the banking industry has a complicated relationship with barriers of entry and competition, this is due to two factors the perceptions of banks as a driving force behind economic stability or instability and a theory among policy makers that excessive competition in the banking industry is harmful to the overall efficiency of the market, tactically avoiding price wars and aggressive advertising campaigns.
Investopedia (2019)

Numerous neoclassical and free-market economists have argued that increased competition in the banking and finance industry in the United Kingdom would lead to lower costs and improved efficiencies. These arguments assert that the incentives of free competition can create an atmosphere among firms that would improve quality, customer responsiveness and product innovation. The theoretical models of Besanko and Thakor (1992) further suggest that financial products and capital structures are heterogeneous and a relaxing of entry barriers would lead to declining loan costs and increasing interest rates on current accounts. This, ultimately, would lead to higher growth rates in the greater economy.

Within the UK banking and finance industry it is generally expensive to establish a new bank or financial services company due to high fixed costs and large sunk costs in the production of financial services. As a result, this causes it to be difficult for start-ups to compete with the leading firms that have scale efficiencies and act as an oligopoly. Regulatory barriers exist between commercial banks and investment banks. As a result the costs of compliance and threat of litigation are sufficient to deter new products or firms from entering the market.

As a result of outdated regulatory barriers and examples of collusion within the UK banking and finance industry the Financial Conduct Authority (FCA) have introduced new regulations to combat the barriers of entry to the market as a result of a collusive oligopoly being present, for example, the FCA publication ‘ An evaluation of reducing barriers to entry into the UK banking sector’ FCA (2013)  which reads, “ The rate of entry into the UK banking sector is higher than before the 2013 review. While not all entry can be solely attributed to the changes in the authorisations process, firm interviews have indicated that the interventions have encouraged entry into the UK banking sector.” These regulations included The FCA’s approach to authorising new banks or banks that are expanding their activities, aiming to:

* Balance our objective to promote competition in the interests of consumers
* Apply appropriate barriers to entry to deliver consumer protection.
* Ensure that the approach does not cause disproportionate barriers to entry or expansion, and by doing so, have an adverse effect on competition.

Therefore, as a result benefiting the UK banking and finance industry, increasing competition within the market for the ongoing future. In contrast this will not limit the leading banks in the UK and decrease their market power, but instead, forge non collusive ties, for example Even without collusion, when oligopolies conduct business, they still have to take into considerations the reaction of their competitors, This leads us to the kinked demand theory. The kinked demand theory assumes that if an oligopolist increases prices then their competitors will not since if they keep their prices lower, they will gain more customers than the acting firm, whereas if the oligopolist in this case HSBC cuts its prices then the rivals will follow to maintain market shares and prevent losing customers to the acting firm. The outcome is continued price stability within the market.

6. Summary

In summary we can observe the determinants to the UK banking and finance industry, the industry is clearly oligopolistic with high levels of competition due to the wideness of services that are offered. The market holds a concentration ratio of 89. 82%, resulting in significant barriers to entry for smaller/start-up firms. In addition, as a result of the oligopolistic market we can observe various degrees of barriers to entry and how barriers of entry can be resolved through government intervention or crisis.

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