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How do UK financial institutions really price their banking products?

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Abstract

This paper has several objectives. The first is to explore the type (or types) of imperfect competition that prevailed in the retail banking sector in the 1990s. A general linearised pricing model is employed to test for the degree to which competition in certain markets deviated from the competitive ideal. The key finding, is that, with the exception of mortgage products, deposit and loan rate setting by UK financial institutions is best described by the Salop–Stiglitz model of monopolistic competition, with bargain and rip-offs. Cournot type behaviour is evident in some cases. Indirectly, the presence of perfect contestability is largely ruled out. Another objective is to compare these findings with the results of a similar study conducted nearly a decade ago, when financial reforms introduced to encourage greater competition were relatively recent. Based on the results of this study, the policy *lesson* is that financial firms exhibit different types of price setting behaviour depending on the banking product. The policy *implication* is to require firms to produce comparable information for consumers, thereby helping to contain the loss of consumer surplus in imperfectly competitive markets.

JEL classification: C23; D21; D43; L13; G21

Keywords: UK retail banking markets; Models of imperfect competition; Bargain and rip-off products; Information asymmetries; Cruickshank banking review

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1. Introduction

This study analyses the pricing behaviour of UK financial firms offering five generic products, savings accounts, higher interest cheque accounts, mortgages, credit cards, and personal loans. Rates for deposit products are quoted for low and high deposit amounts. All rates are monthly, covering the period 1993–1999. Unlike the US but similar to Canada, UK retail banking is a national market, where deposit and loan rates quoted to customers by a given bank or building society apply across the country.

This paper has several objectives. One is to provide *direct* evidence (for or against) of the extent to which the pricing behaviour of five well-known retail banking products is competitive. The presence of information asymmetries and consumer inertia in this market generates the potential for market imperfections, even if there are many firms offering a product. A second objective is to explore which model (or models) of imperfect competition best describe the retail banking market in the 1990s. Using a generalised pricing model, it is possible to test for the degree to which the different product markets deviate from the perfectly competitive ideal, Cournot oligopoly, the Salop and Stiglitz model of monopolistic competition with bargains and rip-offs, and, indirectly, contestability.

Third, where possible, the results of this study are compared to the findings in Heffernan (1993), which looked at competition in this sector between 1985 and 1989, when reforms implemented to encourage greater competition in the retail financial markets were relatively new. Was there any empirical evidence to support a *law of one price* in the British retail banking? The answer then was an unequivocal *no*. Has it changed as Britain enters the 21st century, and if so, why?

The main difference between the two studies is the dramatic increase in the number of firms offering key retail banking products, and the availability of data on the deposit and loan rates quoted by these firms. For example in the earlier study, a total of 17 firms made up the sample, whereas in this work, there are six different classes of financial institution.

The paper is divided into several sections. Section 2 describes how the data were collected and sorted. Section 3 describes, tests, and analyses the results from the econometric model. Section 4 discusses the findings from the econometric tests. Section 5 concludes, makes some policy recommendations, and compares these with the conclusions of the recent Cruickshank Banking Review. [1]

[1] The Chancellor of the Exchequer, in his 1998 pre-budget report, announced an independent review of banking services. Mr. Don Cruickshank, a former regulator in the telecommunications industry, was appointed Head of the Review. The Cruickshank Review examined competition in the banking sector for retail consumers and small to medium sized firms.