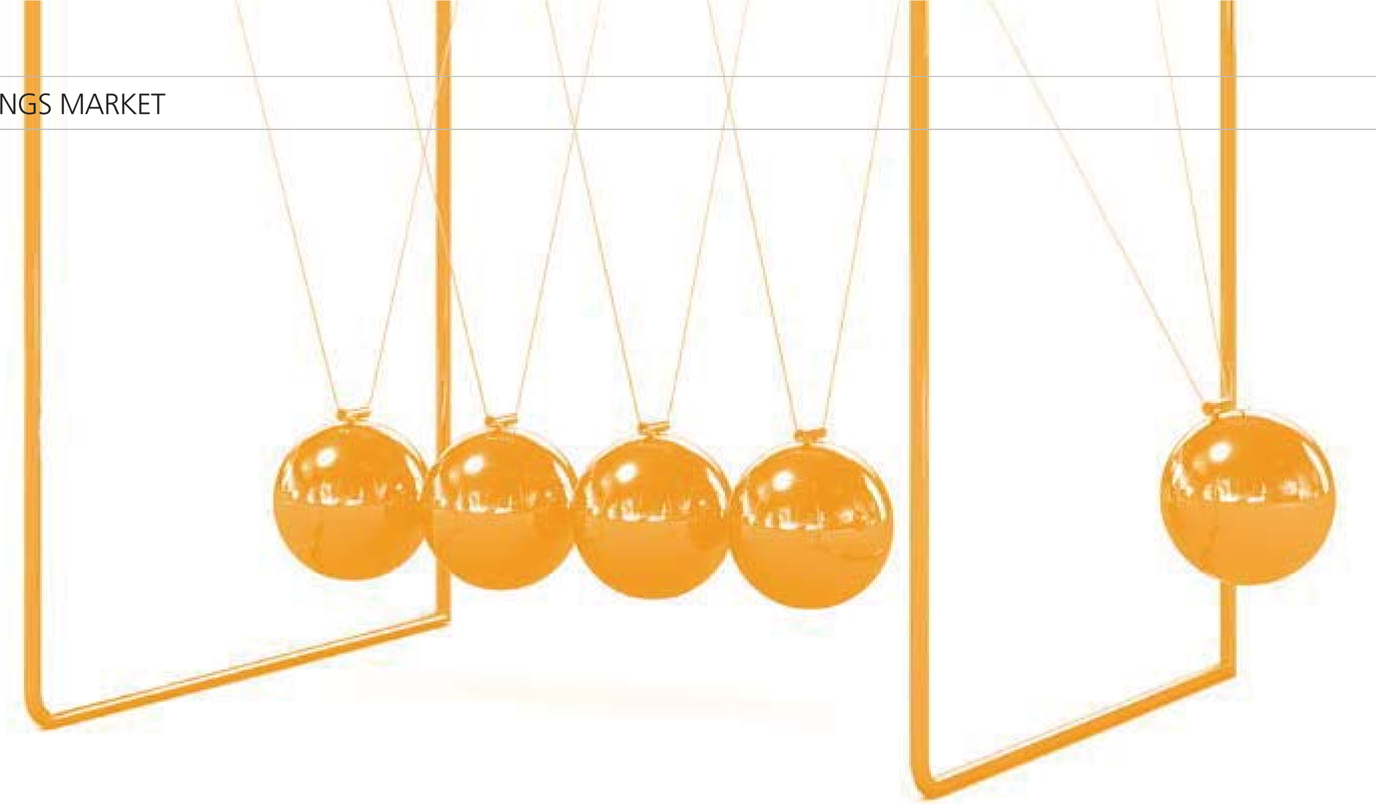

Has the PENDULUM SWUNG too far?

The cash savings market has a critical role in providing stable funding for banks and in enabling access to saving services. Research by JOHN ASHTON, ROBERT ANDERSON and ROBERT HUDSON examines the market.

The tendency for banks to rely on funding from capital markets typified the financial crisis of 2007-8. This subsequently swept through worldwide financial markets and was also central to the collapse of retail banks such as Northern Rock in the UK.

As a result, the cash savings market's multiple roles have caught the attention of many regulatory and consumer bodies, as well as influencing changes following the Basel III agreement. One of those key changes was a rise in the status of retail savings within the management of bank liquidity risk.

Retail deposits offer a number of benefits to banks – not least the relative stability of retail funding, with depositors having fewer incentives to monitor banks and withdraw funds based on negative public signals.

THE ISSUES

Despite the widespread consensus of such benefits, the UK cash savings market has become the focus of financial regulators, the government and consumer representatives alike, all demanding change.

It has been widely claimed that savers are not receiving a good deal. Recent reports from organisations such as the Financial Conduct Authority (FCA) and the Consumers' Association (*Which*) claim:

- Consumers face difficulties in navigating this market and are reluctant to switch supplier
- The scope of deposit products offered is excessive
- Informed customer decision making is constrained.

Solutions to these concerns have ranged from enhanced switching services, a cull of 'zombie' and superseded accounts offering poor returns and clearer information provision.

New guidelines on liquidity risk management have received widespread support and are set to be implemented internationally. They encourage the development of deposit balances with lower 'run-off' ratios – accounts which consumers switch away from infrequently.

It has been argued that these policies could be hindered following the recent calls to enhance the ease of switching accounts and to heighten the responsiveness of depositors to changing market information.

THE ANALYSIS

In light of this disputed policy terrain, it is important to investigate these policy decisions and determine whether recent developments have indeed gone too far. Our research examined the UK cash savings market and reviewed recent evidence on competitive conduct within the industry.

The report asked a question at the heart of the recent discontent – if depositors are unlikely to switch banks, can these banks extract rent from their existing depositors? Or, in other words, are depositors who don't switch and maintain a long-term relationship with their bank losing out on returns received?

To answer this question, a large data set of instant access deposit interest rates was reviewed, offered monthly by UK firms between January 1989 and December 2011. The 572 deposit accounts were examined for three interest rate tiers of £500, £5,000 and £50,000 over three time periods.

THE RESULTS

Following the analysis, a clear pattern emerged indicating that older deposit accounts have lower interest rates. Overall, the depositor would benefit from shopping around and changing banks, with the more loyal depositor experiencing the financial cost of lower interest.

The implications of these findings are multifaceted. From a prudential regulation perspective it is important to allow banks access to a stable and low cost source of funding in the form of retail deposits, which are held at the same bank over repeated periods of time by depositors. The current situation of low switching levels and low returns for long-term depositors is clearly advantageous to banks.

Despite evidence of the situation not being in the best interest of depositors, it is crucial that regulators recognise the cash savings market as central to multiple policy objectives.

A striking feature of these debates has been their discretion. It is hoped that future discussions, from either competition or prudential regulators, acknowledge the importance of different viewpoints and that inconsistent and possibly antagonistic policy decisions do not arise.

> *"It is important to allow banks access to a stable and low cost source of funding in the form of retail deposits, which are held at the same bank over repeated time periods by depositors."*

While the market may require change, and long-term depositors should certainly expect a better deal from the banks, any practical solution to concerns arising in the cash savings market must reflect these divergent policy requirements. CB

The study considered in this article is published in the Journal of International Financial Markets, Institutions and Money. Reference: Anderson, R., Ashton, J. K. and Hudson, R. (2014) 'The Influence of Product Age on Pricing Decisions: An Examination of Bank Deposit Interest Rate Setting', Journal of International Financial Markets, Institutions and Money. Vol.31, pp.216-230.