Structural Deregulation and Market Entry: The Case of Financial Services

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I. INTRODUCTION

A major policy initiative over the past decade or so has been the deregulation of professional and financial services. In particular, reforms have been directed at structural deregulation, i.e. the removal of restrictions upon entry to or exit from specified markets and upon the permissible range of a firm’s activities. In some cases changes have been achieved via negotiation with self-regulatory professional bodies and in others through legislation and statutory direction. In either event, the effect of removing entry restrictions has frequently been to trigger an inward rush for market positions, typically followed by a later exodus of the unsuccessful entrants. Whatever the long-term consequences of relaxing entry rules, this immediate entry race has attracted criticisms. It has been suggested that it encourages overbidding for existing assets (Wright, Ennew and Starkey, 1992) and the creation of unnecessary capacity. A number of commentators have blamed the severity of the current UK recession on the excesses of credit expansion in the aftermath of financial services deregulation.¹

The purpose of this paper is to consider structural deregulation and the nature of the strategic entry opportunities it offers. The paper then presents an examination of the exploitation of those in financial services, following the

¹ A view since partially endorsed by the then Chancellor of the Exchequer — see Lawson (1992).
It is suggested that structural regulation segments markets and prevents the realisation of economies of scope. Segmentation also creates an artificial homogeneity among members of the industry. Unfortunately, this tends to destabilise the processes of innovation and the pursuit of new opportunities within an industry. In unregulated industries, firms’ capabilities — and hence their strategic options — differ as their growth paths diverge as a result of random shocks and subsequent adjustment. Richardson (1990) shows how this co-ordinates innovation by making new opportunities differentially attractive to some members of an industry. Historically, financial intermediation has been characterised by especially tight structural regulation — so much so that hard evidence on economies of scope is scarce, even for market participants. In these circumstances it is scarcely surprising that a relaxation of the rules on diversification should have triggered such a rush into new activities, nor that some of this entry now appears unfortunate.

Section II examines the background to the deregulation of financial services. Section III looks at the nature of the opportunities created by structural deregulation. Some evidence on building society diversification is presented in Section IV, and Section V presents some brief conclusions for regulatory reform.

II. THE BACKGROUND TO STRUCTURAL DEREGULATION

In the countries of Europe and in the US, financial intermediation has probably attracted more regulatory attention than any industry other than supposed natural monopolies (Baltsenperger and Dermine, 1987; Kane, 1984; Litan, 1987, Ch. 2). The proximate cause of intervention has usually been an economic or financial crisis. In the UK the whole dominant tradition of joint-stock, high street banking dates back to early nineteenth century responses to credit crises, when the Bank Charter Acts restricted note issue and stimulated joint-stock branch banking. More recently, the secondary bank crisis of 1973–74 triggered stricter criteria distinguishing recognised banks from deposit-taking institutions. These were devised in 1975 and later incorporated in the 1979 Banking Act. Similarly, the restrictive legislation constraining the structure and conduct of US banking largely dates from Roosevelt’s initial response to banking failure during the Great Depression. For example, the 1933 Banking Act was designed to restrain what had been considered excessive competition between banks, whilst the Glass–Stegall Act of the same date enforced a separation between retail banking and investment banking, including the underwriting of securities (Litan, 1987, pp. 24–33; Clarke, 1986, pp. 36–45).

Despite these origins, most regulatory interventions may be interpreted as counters to some actual or potential market failure (Kay and Vickers, 1988). For example, again in the US context, restrictions on interstate banking and holding
company acquisitions may be considered as devices to check the growth of monopoly power. Similarly, much of the traditional regulation of the conduct of financial intermediaries is explicitly designed either to protect the interests of depositors and/or to reduce the probability of bank failure. This may be as a means of mitigating the market problems associated with asymmetric information (in this case between the depositor as lender and the bank as investor) or as a device to reduce the external costs of failure, with its risk of contagious runs elsewhere in the financial system. Whether this type of regulation really does promote stability is debatable: proponents of ‘free banking’ argue that transfers of funds tend to stabilise the system by favouring banks whose activities are transparent and sound (Dowd, 1987).

Structural regulation may be intended to counter any of the types of market failure discussed above. However, it has been particularly prevalent in cases where information asymmetry would leave clients vulnerable to opportunistic behaviour. Two categories of such problems frequently encountered in financial services concern the provision of unbiased advice and the stabilisation of risk in financial intermediation.

First, regulation is frequently used to separate related activities where one such activity involves advising clients about the use of another. For example, prior to ‘Big Bang’ deregulation the Stock Exchange separated the stockbroking and market-making (‘jobbing’) functions. Similarly, the 1986 Financial Services Act introduced a requirement that those selling selected investment products to the public opt for either ‘tied’ or ‘independent intermediary’ status. Clients using ‘tied’ agents are presumed to be thus informed that the seller has a direct interest in the outcome. By contrast, ‘independent intermediaries’ are required to give ‘best advice’ to the client and to this end must necessarily engage in more staff training and greater information disclosure (Drake, 1989, pp. 109–11).

Structural regulation is also used to limit the activities of financial intermediaries. Given the existence of a general risk–return trade-off, any financial intermediary may be tempted to substitute higher-risk assets for lower-risk ones, thus increasing its average return at the expense of the liabilities of the owners of the firm, i.e. deposit holders in the case of banks or building societies. Where these liabilities are effectively insured or guaranteed, the deposit holder has no incentive to monitor such risk-increasing behaviour. The American Savings and Loan Debate was at least in part a consequence of demutualised and partially deregulated savings banks using the security of deposit insurance to invest in high-risk property developments. The crisis was then exacerbated by an intensified moral hazard problem as the now technically insolvent savings and loans continued to trade and search for ultra-high-risk activities, knowing that the regulatory authorities would have to take care of the consequences (Mishkin, 1992).

By imposing limits on the range and extent of non-core activities undertaken by financial intermediaries, regulation tries to reduce the scope for such
inefficient risk-shifting behaviour. However, it is clear that regulatory barriers to
the mobility of assets between related markets convey benefits to both the
regulator and the regulated firms. The regulator’s task is inevitably made easier
when dealing with a set of firms with similar activities and readily comparable
accounts. Similarly, incumbent sellers will benefit from the maintenance of
institutional entry barriers to their markets. Such a situation of mutual gain is
entirely consistent with the ‘capture’ theory of regulation associated with Stigler
(1971) and Peltzman (1976), in which the regulator comes to identify with the
industry’s interests. It is not, of course, necessarily compatible with maximising
either general welfare or the interests of consumers.

Under UK financial services regulation, the segmentation of product markets
was both well determined and long lasting. Industry groups, such as banks or
building societies, enjoyed carefully controlled membership whilst members’
activities were strictly limited to the prescribed core business. Furthermore, in
addition to the formal framework of legislation and regulatory codes, there was
acknowledged to be a strong informal control exercised by the Bank of England
as regulator to the clearing banks and the Registrar of Friendly Societies over the
building societies.

This traditional framework began to break up in the late 1970s and early
1980s as several interrelated developments occurred. First, information
technology and communications improvements hugely increased the data-
processing capacity of financial firms and extended the geographical range of
their operations. Second, these technological advances encouraged the firms to
look for new product and new international markets. Third, the growing
internationalisation of banks, in particular, and — where permitted — the
widening scope of their activities made regulatory control less effective. Banks
began to innovate their way around restrictions such as the UK corset
(abandoned in 1980) or the US Regulation Q ceiling on interest rates (phased out
by 1986) (Litan, 1987, pp. 33–5). Furthermore, an international bank could
escape at least some domestic restrictions by switching funds to a less regulated
country. Thus competition between regulatory regimes to keep financial
operations and jobs tended to encourage deregulation. Fourth, once the process
of domestic deregulation had begun, it inevitably spread across sectors. For
example, as the UK banks diversified in the 1980s, they became major lenders in
the mortgage market, which had been hitherto the preserve of the building
societies. The societies then were compelled to lobby for their own deregulation
to allow them to diversify into other businesses, including some previously
dominated by the banks (Drake, 1989, Ch. 4).

It might be added that the 1980s also saw the electoral success of
governments in the UK, US and many European countries which were
committed to deregulation as a pro-competitive stance. However, the
technological and economic developments necessitated liberalisation. As Stigler
(1986, p. 9) remarked, these developments ‘can be explained without recourse to

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a revulsion against public regulation. In explaining why one does not walk from Dover to Calais it should suffice to point to the Channel, without adding that such a long walk would be fatiguing’.

III. STRUCTURAL DEREGULATION AND ENTRY OPPORTUNITIES

It is axiomatic that firms enter new markets where they perceive opportunities for profit. The latter may come about because these markets have enjoyed some shelter from competitive forces and hence offer rents, even to entrants with no particular cost advantage. Alternatively, market entry may be the indirect result of a vertical integration decision: for example, where a firm acquires capacity to produce its own input, it may enter the input’s market to sell sufficient to keep the overall average cost at an acceptable level. Finally, a firm may make a diversifying entry into another market where it perceives the costs of supplying both products together to be lower than that of their separate supply. Such economies of scope (Teece, 1980 and 1982) typically result from the more intensive use of one or more common input. This could be a physical asset, such as capital equipment, or a shared brand name, or a human and organisational asset including that of management itself (Penrose, 1959).

Of course, the profits anticipated by new entrants frequently prove illusory. Geroski (1991) finds that most industries are characterised by surprisingly high rates of entry and exit: ‘The raw data suggest that entry is, apparently, rather easy and, by implication, that entry barriers are rather low. However, what is much more difficult is post-entry market penetration and indeed survival’ (p. 285). He likens the experience of the new entrant to ‘trial under fire’, which few survive.

This comparatively open — if risky — access to markets enjoyed by potential entrants in most industries may be contrasted with the barriers to entering many regulated activities. These may be more or less onerous in the difficulties they place on would-be entrants. However, in the limit, structural regulation may prohibit any firm within the designated industry from entering any related activity. This prevents the normal process of entry trials and leaves unexploited potential economies of scope, whilst at the same time thwarted potential entrants may be aware of these supra-normal profit opportunities. Of course, the incumbent firms may prefer to take their regulatory rents as, for example, discretionary expenditure so as to avoid the interventions that high profits would trigger.

It is hardly surprising if rapid entry follows the removal of structural restrictions. However, the entry process appears likely to be more turbulent than in the case of conventional unregulated industry.

First, as noted by Geroski and Schwalbach (1991) and their contributors, entry rates are usually highly correlated with exit rates. Deregulation, by contrast, produces — initially at least — a one-way flow.
Second, precisely because market segmentation prevents entry trials, the information on economies of scope may be largely conjectural — this is particularly likely where the projected economies rely mostly on intangible assets, such as brand-name capital or human expertise.

Third, where prior segmentation has preserved an artificially high level of homogeneity among members of an industry, their responses to entry opportunities may be based on very similar considerations — with similar outcomes. Richardson (1990) argued that firm-specific differences provide a co-ordination mechanism for the introduction of new innovations: ‘there will generally be substantial difference in the period of time which would have to elapse before different firms would be prepared to invest in response to a recognized profit opportunity’ (p. 60). In an analogous fashion, the supply of new entrants may be ordinarily limited by inter-firm differences — but segmentation will reduce them.

Fourth, since the lifting of entry restrictions typically applies to a whole set of potential entrants, their initial response cannot be based on a precise estimate of the post-entry market structure. However, if there are first-move advantages (Grilli, 1989) — for example, entering an insurance market where clients, once contracted, face switching costs when changing policies — the potential entrant is more likely to join earlier rather than wait to see how rivals respond.

Fifth, regulation tends to restrict product differentiation (or, as Bailey (1986, p. 15) puts it, ‘Regulatory bureaucrats fail to recognise all of the dimensions of product characteristics space...’). It has been found in a number of cases, including UK express coaches (Jaffer and Thompson, 1986) and US air and ground transport (Bailey, 1986), that deregulation is accompanied by significant product differentiation as producers try to uncover underlying demand characteristics. In some instances, particularly in transport industries, producers have located previously unsatisfied demands for low-price/lower-quality services.

Finally, if the managerial labour market is imperfect in its ex post settling up, as most analysis shows, managers may have discretion to exercise a natural preference for growth opportunities. This will be accentuated where any failure to follow rivals’ diversifications may require a justification and where any subsequent failure is likely to be commonplace across the industry and hence will not attract individual sanction.

In short, if entry even under normal conditions is highly risky, frequently short-lived and very often unprofitable for the entrant, entry following deregulation appears likely to be very rapid, uncoordinated and associated with...

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2 Fama (1980) argues that the managerial labour market may be judged efficient if it uses information to reward managers in a manner analogous to the capital market’s pricing of securities. However, he suggests that some may be used for ex post settling up, i.e. for example, in penalising those whose effort has been unsatisfactory. However, much evidence indicates that poor results are inadequately punished, e.g. Schmidt and Fowler (1990) report that mergers worsen profitability but raise managerial remuneration.
Structural Deregulation

particularly high rates of failure. This poses a paradox for the policy-makers: structural deregulation removes obvious restrictions on allocative and productive efficiency, but the very opportunities it creates may give rise to ‘excessive’ entry, unnecessary capacity and perhaps systematic destabilisation. A complete evaluation of the net gains from structural deregulation in the 1980s must await two factors: first, a return to stability in the affected markets to determine the lasting impact on competitive structure performance. Here, it is not simply the deconcentration effect which is important but also the introduction of potential competition. Second, observations are required over all the phases of the business cycle. In the mean time, there is fragmentary evidence covering many of the affected industries. Johnson (1990), for example, reports that financial services firms were responsible for substantial net new entry in estate agencies (from 14,000 in 1985 to 17,000 in 1988), with much accompanying acquisition activity. This was followed by significant net exit between 1988 and 1991. Lomax (1988) describes entry to and subsequent exit from security trading, following the abolition of the dual-capacity (broker–jobber) restriction in the 1986 ‘Big Bang’.

The remainder of this paper seeks to present some more systematic evidence of the extent and causes of new product market entry by building societies. It also examines the extent to which collaboration and/or off-balance-sheet arrangements have been used as alternatives to fully owned entry ventures. The large number of members and the homogeneity of the building society sector on the eve of deregulation make it particularly appropriate in this context.

IV. DIVERSIFYING ENTRY BY BUILDING SOCIETIES

The 1986 Building Societies Act, together with some subsequent clarification, gave the societies qualified freedom to enter a range of financial and property-related product markets and to acquire business and enter collaborative arrangements. The principal restrictions were quantitative. First, the societies’ total commitment to those classes of asset (Classes 2 and 3 in the 1986 Act) which were considered more risky — unsecured lending, property development — was not to exceed a limited proportion of total assets. This was to rise from an initial 10 per cent to a maximum of 25 per cent in 1992. (Hence deregulation incorporated a deliberate check on the moral hazard problem whereby financial intermediaries substitute high-risk assets for low-risk ones, as some US savings and loans had done.) Second, access to the full range of new activities was

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3 There were also qualitative restrictions — for example, requiring that some diversified activities be operated by subsidiaries rather than the parent. As it is not at all clear that the regulator would allow the parent to walk away from any losses incurred by the subsidiary, the consequences of the separation are unclear. Separation does ensure greater transparency in the society’s accounts.
restricted to the larger societies — those with commercial assets above 100 million.

Both of these restrictions were expected to limit diversifications by medium to smaller societies. The 100 million threshold directly debarred over half of the then industry population from participating in some riskier activities. The balance sheet proportional restrictions were expected to limit the range of activities undertaken by medium-sized societies since there will be fixed entry costs to entering these activities. Furthermore, all societies would have been conscious that, as financial mutuals, they lacked any source of equity capital and hence had to finance new developments largely out of reserves, supplemented by subordinated debt. This restriction is obviously important when new entry may require sustaining losses over a considerable period.

Diversification need not involve the full ownership of new activities. The 1986 Act allowed the societies to form collaborative ventures with other firms. Hence an alternative mode of exploiting a particular asset — say, the retail potential of the branch network — was to form an arrangement with an established supplier of the product. This could range from an affiliate company which, for example, left the society as merely a marketing agent, through to a joint venture in which the society made a major investment. Collaborative ventures — both jointly owned and affiliate company arrangements — are an obvious way of spreading risk and acquiring access to expertise. They also reduce the initial investment requirements by allowing off-balance-sheet financing for the society. A collaborative arrangement with an existing market participant also means that the entrant can transfer resources into the industry without necessarily disturbing that industry’s current competitive structure too much.

The Evidence

The 1986 Act allowed the building societies freedom to engage in limited diversification across a range of product markets. To investigate this, we collected data on the extent and type of society diversification in a telephone survey and postal enquiry in Autumn 1991 — three-and-a-half years after the Act became effective. Product categorisation is difficult in the service sector in general and particularly so in financial services where innovation is rapid. Accordingly, the 13 products chosen were taken from categories used in the UBS Phillips and Drew broker reports (which categories largely followed in the 1986 Act). Twelve products were newly permitted under the legislation and one, automatic teller machines (ATMs), was included because the timing of its adoption exactly coincided with that of the others.

The target population of societies consisted of those still extant in August 1991 which had met the commercial asset threshold of 100 million in 1987. Of 49 such societies, data were obtained from 47. In each case the society was asked
whether it operated in each market and if so, whether its operation was *wholly owned* (either by parent or wholly owned subsidiary) or whether it was a *joint venture or affiliate*.

The product categories, grouped by product area, and the extent and modes of entry are summarised in Table 1. From this it is clear there is substantial variation in the frequency of entry across product markets — from 96 per cent in *general insurance marketing* to 19 per cent in both credit cards and *stockbroking*. However, it is also clear that there has been a remarkably rapid general diversification movement in — at most — a mere three-and-a-half years. This is particularly sudden for a sector previously constrained to a core business. In total, the societies entered 292 out of a possible 611 opportunities (47.8 per cent).

**TABLE 1**  
*Diversification of Larger UK Building Societies, by Product and Mode, 1991*

<table>
<thead>
<tr>
<th>Product area</th>
<th>Product</th>
<th>Number (percentage) providing:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>On own</td>
</tr>
<tr>
<td>Equity-related products and services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal Equity Plans</td>
<td>10 (21)</td>
<td>6 (13)</td>
</tr>
<tr>
<td>Unit trusts</td>
<td>8 (17)</td>
<td>8 (17)</td>
</tr>
<tr>
<td>Pension plans</td>
<td>6 (13)</td>
<td>16 (34)</td>
</tr>
<tr>
<td>Stockbroking</td>
<td>2 (4)</td>
<td>7 (15)</td>
</tr>
<tr>
<td>Insurance etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General insurance</td>
<td>38 (81)</td>
<td>7 (15)</td>
</tr>
<tr>
<td>Investment advice</td>
<td>22 (47)</td>
<td>14 (30)</td>
</tr>
<tr>
<td>Retail banking</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current accounts</td>
<td>6 (13)</td>
<td>10 (21)</td>
</tr>
<tr>
<td>ATMs</td>
<td>1 (2)</td>
<td>21 (45)</td>
</tr>
<tr>
<td>Credit cards</td>
<td>4 (9)</td>
<td>5 (11)</td>
</tr>
<tr>
<td>Unsecured loans</td>
<td>8 (17)</td>
<td>32 (68)</td>
</tr>
<tr>
<td>Offshore accounts</td>
<td>14 (30)</td>
<td>0 (0)</td>
</tr>
<tr>
<td>Estate agencies</td>
<td>23 (49)</td>
<td>0 (0)</td>
</tr>
<tr>
<td>Property development</td>
<td>15 (32)</td>
<td>10 (21)</td>
</tr>
</tbody>
</table>

Sources: UBS Phillips & Drew reports (various); authors' telephone survey and postal enquiry.

The use of joint ventures or affiliates was almost as frequent (135 cases — 21.1 per cent) as that of wholly owned activities (157 cases — 25.7 per cent). It is also clear that while collaboration is found among societies of all sizes in the sample, it is proportionately more important for the smaller ones. In Table 2 the sample is ranked by size quartile and the use of joint ventures is analysed. It can be seen that whilst the frequency of joint venture or affiliate entry falls between the first and fourth quartile, it does so by very much less than the frequency of
all entry. Thus the use of the wholly owned venture declines sharply with size. This is seen in the increase in the joint-venture:fully-owned ratio from 0.47 to 2.0 over the quartiles. The particularly high level of joint venture entry in the second quartile probably reflects intense efforts of societies on the fringe of the leading group to keep up with their larger rivals.

<table>
<thead>
<tr>
<th>Size quartile</th>
<th>Ratio of joint venture or affiliate to wholly owned entry</th>
<th>All entry as proportion of opportunities</th>
<th>Joint venture or affiliate entry as proportion of opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.47</td>
<td>0.74</td>
<td>0.24</td>
</tr>
<tr>
<td>2</td>
<td>1.29</td>
<td>0.51</td>
<td>0.29</td>
</tr>
<tr>
<td>3</td>
<td>0.97</td>
<td>0.39</td>
<td>0.19</td>
</tr>
<tr>
<td>4</td>
<td>2.0</td>
<td>0.25</td>
<td>0.17</td>
</tr>
</tbody>
</table>

a In descending size order; 12 societies in first three quartiles and 11 in the last. Sources: Authors' survey; UBS Phillips & Drew reports.

It is too early in the building societies’ experience as providers of diversified financial services and too soon in the business cycle to make an assessment of any efficiency gains. The onset of recession has certainly hit the performance of those societies which moved into new property-related markets. Similarly, the impact on allocative efficiency in those markets receiving new building society entrants is difficult to determine until the markets themselves stabilise. However, it is possible to examine the diversification strategies — as revealed in our data — and determine the extent to which these appear to follow the resource endowments of the societies themselves, and hence the extent to which they appear to be motivated by the desire to exploit economies of scope.

Following Penrose (1959) and Teece (1980), a firm’s diversification may be considered as a means of better utilising its specific assets or capabilities. Determining what these are in the particular contexts of building societies is not straightforward. However, after Litan (1987) who considers sources of economies of scope in US banking, the following appeared to be the relevant assets:

(a) under-utilised investments in information technology;
(b) the branch network, as an asset in cross-selling financial products;
(c) the brand-name capital of the societies; and
(d) human expertise which should be at least partially transferable to related markets.
The diversification data did not reveal the extent of a society’s investment in a particular market, merely the mode of entry. Accordingly, an index (DIV) was constructed, depending upon whether society $w$ had entered market $i$ using mode $j$ ($j=2$ for own entry, $j=1$ for joint venture or affiliate and $j=0$ for no entry). That is,

$$\text{DIV} = \frac{\sum_{j=1}^{13} w_{ij}}{26}$$

It was not feasible to get data on past information technology investments, but the other hypothesised capabilities — branch network assets, human expertise and brand-name capital — were proxied as follows:

- **Branching Intensity** = \(\frac{\text{Number of branches, 1986-87}}{\text{Assets (1987, £ thous.)}}\)

- **HQ Staffing Intensity** = \(\frac{\text{HQ staff, 1986-87}}{\text{Assets (1987, £ thous.)}}\)

- **Advertising Intensity** = \(\frac{\text{Advertising expenditure, 1983-86}}{\text{Assets (averaged 1983-86, £ thous.)}}\)

To capture other, non-specified, assets and to reflect the constraints of the new regulatory regime, a SIZE term was included, together with its square to capture non-linearities. Finally, it was recognised that building societies — as mutual companies — cannot raise equity and hence may face difficulties in financing expansion. Therefore a balance sheet variable, RESERVES, was used to capture accumulated surplus. Thus:

- **SIZE** = \(\text{Assets (1987, £ thous.)}\);
- **SIZE}^2 = \text{SIZE squared};\)
- **RESERVES** = \(\frac{\text{Assets (1987, £ thous.)} - \text{Liabilities (1987, £ thous.)}}{\text{Assets (1987, £ thous.)}}\).

The principal data sources were the Tekron Database of AR11 reports and society accounts and the BSA Yearbook. In each case, except advertising, values were taken as closely as possible to 1 January 1987 when the new regulatory regime began. For advertising intensity a longer time period, 1983–86, was used to guard against the possibility of reverse causation, i.e. that those societies
which planned rapid diversification might have invested in brand-name creation immediately prior to deregulation.

As DIV, the dependent variable, was itself a proportion, a log odds transformation was employed (Neter and Wasserman, 1974, pp. 330–2) before it was regressed on the explanatory variables. The results are given in Table 3.

**TABLE 3**

**Determinants of Building Society Diversification Levels: OLS Estimates (Dependent variable log odds transformation of the diversification score)**

<table>
<thead>
<tr>
<th>Variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SIZE</td>
<td>0.261</td>
<td>0.287</td>
<td>0.305</td>
<td>0.182</td>
<td>0.208</td>
</tr>
<tr>
<td></td>
<td>(2.86)</td>
<td>(3.37)</td>
<td>(2.93)</td>
<td>(2.44)</td>
<td>(2.08)</td>
</tr>
<tr>
<td>SIZE²</td>
<td>-7.475 x 10⁻³</td>
<td>-8.109 x 10⁻³</td>
<td>-9.273 x 10⁻³</td>
<td>-5.123 x 10⁻³</td>
<td>-6.788 x 10⁻³</td>
</tr>
<tr>
<td></td>
<td>(2.43)</td>
<td>(2.83)</td>
<td>(2.67)</td>
<td>(2.08)</td>
<td>(2.16)</td>
</tr>
<tr>
<td>BRANCHING INTENSITYᵃ</td>
<td>6.204</td>
<td>6.520</td>
<td>6.159</td>
<td>5.956</td>
<td>5.819</td>
</tr>
<tr>
<td></td>
<td>(1.64)</td>
<td>(1.80)</td>
<td>(1.46)</td>
<td>(1.99)</td>
<td>(1.90)</td>
</tr>
<tr>
<td>HQ STAFFING INTENSITYᵃ</td>
<td>-4.815</td>
<td>-4.131</td>
<td>-5.484</td>
<td>-3.30</td>
<td>-3.42</td>
</tr>
<tr>
<td></td>
<td>(2.50)</td>
<td>(2.22)</td>
<td>(2.55)</td>
<td>(2.14)</td>
<td>(1.80)</td>
</tr>
<tr>
<td>ADVERTISING INTENSITY 1983-86ᵃ</td>
<td>1.012</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>(3.13)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ADVERTISING INTENSITY 1985-86ᵃ</td>
<td>—</td>
<td>0.780</td>
<td>—</td>
<td>0.700</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(3.81)</td>
<td></td>
<td>(4.12)</td>
<td></td>
</tr>
<tr>
<td>ADVERTISING INTENSITY 1983-84ᵃ</td>
<td>—</td>
<td>—</td>
<td>0.332</td>
<td>—</td>
<td>0.355</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.80)</td>
</tr>
<tr>
<td>RESERVES</td>
<td>-0.067</td>
<td>-0.066</td>
<td>-0.063</td>
<td>-0.049</td>
<td>-0.056</td>
</tr>
<tr>
<td></td>
<td>(0.89)</td>
<td>(0.92)</td>
<td>(0.75)</td>
<td>(0.82)</td>
<td>(0.76)</td>
</tr>
<tr>
<td>BANKING STRATEGY</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>0.947</td>
<td>0.987</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(4.35)</td>
<td>(3.58)</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.82</td>
<td>-0.90</td>
<td>-0.26</td>
<td>1.32</td>
<td>-0.75</td>
</tr>
<tr>
<td></td>
<td>(1.14)</td>
<td>(1.28)</td>
<td>(0.32)</td>
<td>(2.25)</td>
<td>(1.07)</td>
</tr>
<tr>
<td>R²</td>
<td>.65</td>
<td>.68</td>
<td>.57</td>
<td>.79</td>
<td>.66</td>
</tr>
<tr>
<td>R²</td>
<td>.59</td>
<td>.63</td>
<td>.50</td>
<td>.75</td>
<td>.60</td>
</tr>
<tr>
<td>n</td>
<td>45</td>
<td>45</td>
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</table>

Note: Figures in parentheses are t-ratios.

It is apparent that there is a strong non-linear size–diversification relationship. This result, which is consistent with that usually reported for unregulated manufacturing firms (Montgomery and Hariharan, 1991), is to be expected if size captures non-specified firm assets. It is also entirely consistent with the balance sheet restrictions on asset diversification imposed in the new regulatory arrangements. Taken together, the coefficients on the SIZE and SIZE²
terms imply that the maximum diversifying effort occurred just below the group of very large, national societies — a result consistent with that observed in Table 2 which shows extra efforts from medium-to-large societies to keep up with their national rivals.

BRANCHING INTENSITY and ADVERTISING INTENSITY, 1983–86, carry the expected positive, significant effects. These findings are consistent with the hypothesis that societies seek to utilise their branch and brand-name assets more intensively by expanding their product range. However, HQ STAFFING INTENSITY is significant with the ‘wrong’ sign. It is not clear whether this is an indication that headquarters staffing is a poor proxy for human capital factors, or whether it identifies societies that are in some sense less entrepreneurial and more bureaucratic. The RESERVES coefficient was insignificant. This may reflect the off-balance-sheet opportunities created by collaborative arrangements.

While ADVERTISING INTENSITY was intended to proxy brand-name capital as a determinant of the diversification decision, it was recognised that causation could run in the reverse direction; that is, societies intending to diversify may have expanded their advertising outlays immediately prior to deregulation. To investigate this, the ADVERTISING INTENSITY variable was separately defined for the years 1985–86 and for the years 1983–84 and our equation was re-estimated. The coefficients were smaller for each of the sub-periods, although the level of statistical significance was higher for 1985–86. The coefficient for 1983–84 was insignificant. However, the quality of data in the advertising variable deteriorates somewhat in the 1983–84 period as the sample becomes affected by mergers and acquisitions among societies.

Finally, it was noted that the literature on strategic diversification frequently indicates a bimodal pattern, with a cluster of firms adopting a narrow focus and another cluster adopting a much broader one. The DIV index showed high dispersion and bimodality could not be rejected. In consequence, a BANKING STRATEGY binary variable was defined, equal to one if the society provided unsecured loans or if it had any involvement (wholly owned or collaborative) in the provision of either cheque-book accounts or credit cards, these three activities being taken to be ‘typical’ retail banking functions. The reasoning was that those societies opting for a banking role would need to offer a range of products to match the services of clearing banks. Including the BANKING STRATEGY variable produced the expected large coefficient and improved the overall fit. It had little impact on the magnitude or significance of the other explanatory variables apart from reducing the coefficients of the SIZE terms and to some extent the influence of HQ STAFFING INTENSITY.

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4 This was to be expected given that larger societies were obviously better placed to attempt to compete with the clearing banks. The correlation coefficient between SIZE and BANKING STRATEGY (r=–0.29) was one of only two indications of any collinearity in the variables. The other was the expected negative (r=–0.40)
The depth of the housing market recession and the decline in financial services marketing make it difficult to comment on the performance consequences of the societies’ behaviour. However, at least six of our sample have subsequently been acquired — usually following the expectation of poor results. An examination of the residuals of our diversification equations gave no indication that these were societies that had either over-diversified or under-diversified relative to their characteristics.

V. CONCLUSION

If structural regulation maintains an artificial homogeneity across any set of regulated firms, its removal appears likely to stimulate a rush for new positions. The deregulation of financial services ended some particularly strict restrictions on firms’ activities and was associated with rapid entry and exit in some markets. The evidence presented in this paper has indicated that the building society sector experienced just such a period of intense diversification in the immediate aftermath of the 1986 Building Societies Act.

It has been shown, however, that the societies have made extensive use of joint ventures and affiliates. This has allowed a wider spread of activities for medium or smaller societies. Whether such arrangements necessarily represent unrestricted ‘first-best’ choices is unclear. The new regulatory regime, by restricting the proportions of societies’ assets which can be committed to non-core business, encourages off-balance-sheet activities. Furthermore, the Financial Services Act polarisation provisions gave additional encouragement to collaborative arrangements in the favouring of ‘tied’ status deals.

An examination of diversification strategy suggested that it is neither random nor a simple reflection of regulatory and size constraints, but that it broadly follows the capabilities of societies, as the Penrose–Teece view of the firm would suggest. That is, the strategy followed appears consistent with an intention to exploit economies of scope arising from specific assets.

REFERENCES


relationship between SIZE and STAFFING INTENSITY — consistent with economies of scale in operation across the sample.