Supplementary lecture: The future of banking

In this lecture, we are going to examine the hypothesis that banks are going into terminal decline, with all financing activities being taken on by markets, institutional investors and investment banks. It will be seen that the "decline" is partly related to a measurement error, whereby banks' activities are wrongly equated to on-balance sheet activities. Whereas there is certainly an evolution in banks' activities, there appears to remain evidence of comparative advantage of banks as institutions.

The decline of banking – rates of return (Llewellyn)

Rates of return - decline in profitability, loss of credit rating, higher costs of capital, pressure to cut costs and dividends

Causes include

- increased competition due to deregulation,
- technological advance improving competitiveness of capital markets,
- financial innovations with the same effect,
- lowering of entry barriers to banking,
- unbundling of financial assets further facilitating entry,
- asymmetric competition where banks are unable to expand into competitors’ fields,

- declines in the value of the bank franchise due to loss of information, monitoring and reputation advantages as well as heightened interbank competition

Usefully analysed in terms of banking theory, whereby banks losing advantages in terms of screening and monitoring relative to markets

Response, decline in traditional banking, shift to fee earning activities

Evidence from balance sheets - shares of intermediation

Falling shares of bank deposits and loans in intermediation and in total financial assets

Decline in long run phenomenon and not just related to last 20 years

Banks assets/GDP ratios have been stable, suggesting continuing role

Adjustment of balance sheet measures for off-balance-sheet, fee earning activities:

Kaufman and Mote (1994) – adding trust services, non-bank subsidiaries and bank operated mutual funds damps decline in US bank share of financial services

Boyd and Gertler (1994) – capitalising fee income eliminates decline (problem of risk evaluation)

The role of institutional investors in banks' decline

Competition on the asset side from capital market borrowing by non-financial firms, price of which was reduced by growth of institutional investors

Competition on liability side from products such as pension claims, life insurance and mutual funds, and most directly from money market mutual funds (liquidity)

Banks response to these challenges was partly sustainable – seeking fee income – and partly not – increasing balance sheet risk to maintain profitability

An economic perspective on banks' future (Rajan 1996)

Similarities in core banking activities of lending and depositing are the need for providing liquidity at short notice (funding on demand and not funding per se)

Scale economies in liquidity provision explain why these activities are combined in commercial banks (individual borrowers' and depositors' demands for funds averaged out)

Illiquid assets and franchise value "reassure" depositors there will not be overnight change in nature of bank

Deregulation and innovation have increased competition, and forced banks to concentrate on essentials of liquidity provision

No longer feasible to fund high quality borrowers, given opaque balance sheet

Outward nature of activity has changed while economic rationale has not
Example, bank guarantees commercial paper but does not fund it – hence monitors and provides liquidity insurance to borrower
Bank loan sales also retain monitoring and screening in the institution
On deposit side, seek to create captive customers by increasing switching costs, increasing range of services
Automation - advantage to large banks
Scope for specialisation (e.g. in global forex)
Local-local, local-global and global-global approaches in terms of operation and product
Scope for wider range of activities, e.g. using information more intensively, cost in terms of reputation risk (as no advice is trusted), or cost of funds (risk of proprietary trading)

Current challenges:

EMU

Various challenges to EU banks from EMU (Disintermediation, competition, financial market conditions, long term comparative advantage)

Increased competition

Excess capacity and its removal

Conceptual issues in measurement of excess capacity

Causes of excess capacity

Measures of excess capacity

Profitability

Risk

Industry structure

Cost-income ratios

Mergers - costs and benefits

Banks currently in merger wave

- Costs include risks to competition, potential operational risks, challenges to supervisors of giant and often cross border institutions, size of institutions could make them “too big to save”
- Benefits include economies of scale, improved corporate governance (due to threat of takeover) and reduction in excess capacity

Conglomeration

Banks respond to the growth of capital markets and institutional investors by developing their own investment banking and asset management businesses
Potential difficulties in terms of contagion/risk to reputation within the institution and conflict of interest
Also management, organisation and risk control problems

Consolidation and strategic positioning in banking (Boot 1999)

Begins from observation of merger wave among domestic banks and broadening of scope

One reason could be increased competition – mergers to cut costs and shift into new business areas

But evidence on scale and scope economies not conclusive – while diversification may destroy value

Strategic considerations seen most crucial:

- bank anticipates new activity in future (e.g. due deregulation), but uncertain on level of demand and on own skills
- expects market for activity to be moderately competitive
- then may enter market early to see if has or can develop appropriate skills
- easiest for established bank in domestic oligopoly

merging helps by creating deeper pockets and diversifying skills may apply more widely to banks uncertain where among “banking activities” has competitive edge

Example is German, Dutch and Swiss banks move into investment banking – accept low returns now for potential future benefits

May be some economies of scale in this specific area (optimal service of client base via mix of products, services, geographical presence)

Notes political dimension - national bias in EU mergers (governments protect flagships) –

and neglect of alliances (avoiding culture clashes in conglomerates)

Predicts mergers will become excessive – lead to reversal, downsizing, focus under pressure from competition