The Role of Bank Business Models in the Financial Crisis

Conference on

Growth and Global Imbalances

Chinese and European approaches

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100YEARS IN BUSINESS EDUCATION

Bank Failure - A Different Lens

- Traditional Approaches to bank failure draw on economics literature
  - Fighting the last war?

- I suggest that we look at the business literature as well

Classical Causes of Bank Failure

- Classical Explanations

- Global Imbalances
- Monetary Regulation
- Prudential Regulation
- Agency Issue → Moral Hazard
- Herding

Let's Examine Recent Failures

- UK normal failure → property + merger
- US normal failure → property + sub-prime
- Spain & Ireland normal failure → property
- Germany → sub prime (remote location)
- Belgium normal failure → property

Characteristics

- The commercial characteristics

    = competitive markets

- Competition problematic when quality not visible

- Banks part of public sector??

Are Banks Special

Eugene Fama

Bank’s comparative advantage

is “insider information” **(not the going-to-jail type)**

DELEGATED MONITORING

- BANKS ACT AS "MONITORS" ON BEHALF OF MARKETS USING THEIR "INSIDER" INFORMATION

- PERFORMING SAME ROLE AS RATING AGENCIES & AUDITORS

EVIDENCE

FAMA: PREMIUM FOR BANK LOANS OVER CP

JAMES & WEIR: SHARE PRICE EFFECT

Implications

In product markets where banks

- do not enjoy or employ "private" or non-public information
- price competitive behaviours will be evident.

Do we observe this Theory to be Plausible in Practice?

What is the Essence of this Theory?

- **Do various banking products conform to our expectations as a result of this theory?**
  - ♣**credit cards**
  - ♣**big ticket loans**
  - ♣**car loans**
  - ♣**Home loans/ mortgages**
- **These are "commodity markets"**
- ***In a sense, "efficient markets" as everybody has the same information***

Let's look at Property as most common cause of bank failure

- Overheating or over-investment in property is the normal cause of failure
- Property lending is always highly competitive
- Both Personal and Corporate
- Why – it's a low information, low comparative advantage type of business

A low information, low comparative advantage type of business – why?

- *How are property loans made?*

- Home Loans/Mortgages
  - Salary X a (arbitrary) factor
  - House value X another (arbitrary) factor
  - House value and salary are public pieces of information

- Commercial property
  - Same approach
  - Loan to value ratio
  - Rental income X a factor

What does this imply?

- Best case outcome for a Property lending transaction is the normal rate of return
- Little/ No chance of exploiting a comparative advantage
- The violent swings of a commodity market are to be expected except that the upside is truncated
  - Volatility exacerbated by high leverage
- More downside than upside

Too Big to Succeed

- **Banks have become dominated by low margin, competitive businesses and products**
- **Consequently, management have focussed on cost reduction**
  - **maybe at the expense of their comparative advantage in collecting "private" information**
- **Comparative advantages in the form of special information have been ignored**
- **With huge downside and little upside**

Implications

- Hard to justify large banks

- Not just because they are too big to fail
- But more because they do little for shareholders
  - Having no real comparative advantages
- No magic regulatory solution - capital levels, etc