Banking at the cross roads
How to deal with marketability and complexity?

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Focus

On micro economics of banking –

- Impact ‘landscape’ of banking on incentives and choices made by financial institutions
- Implications for the desired regulatory and supervisory structures of banking

Fundamental problems in financial sector…

Major structural shifts lead to "fighting for turf"; takes some time for new equilibrium to emerge… just temporary problem? No, more fundamental

→ Key role: information technology and marketability ('changeability')

Message

- True understanding needed about impact information technology on business of banking
  - Tradability and "changeability" key; see more recent financial innovations
- Banks and markets become more and more intertwined
  - Impact financial market conditions on bank behavior
  - Scalability transaction oriented banking
  - Sensitivity to (collective) euphoria
- Ineffectiveness market discipline
- Banks suffer from cost of capital fallacy

Message – 2

- ‘Changeability’ and market sensitivity causes governance problem
  - Systemic risk and correlated strategies
  - Issue of complexity (included TBTF, too-interconnected-to-fail, etc.)
- Excessive engagement in transaction banking in booms damages relationships
- Bank choices in terms of scale and scope of activities worsen complexity problem
  - Many banks continue to go for size, conglomerate model
  - Can ownership structure help?

Message – 3

- Key problem with alignment market forces and prudential objectives suggests need structural measures
- Dealing with complexity primary challenge
  - Behavioral regulatory measures (e.g. capital requirements) important, yet insufficient
  - Living wills could help, but complexity needs to be dealt with ex ante
- Structural measures needed?
  - Volcker rule and beyond…
- Lack of research on cost/benefit trade-off

Information technology and banking

What did information technology do to banking?

→ Extreme tradability and 'changeability'

- Risk profile can be changed instantaneously….
- Institutions and markets intertwined

Risks via

- Opportunistic behavior
- Herding behavior

→ Financial market linkages key

How to look at financial innovations?

- Extensive literature shows value of security design
  - Spanning
  - Other direct benefits for real activities (e.g. commercial letter of credit)
- Yet this literature may say little about more recent financial innovations
  - (Often?) creating opaqueness rather than resolving asymmetric information
  - Aimed at regulatory arbitrage only?

  → Opened up bank balance sheet: marketability and changeability key

Market discipline?

- Sensible complementary ‘tool’. Idea behind third pillar Basel II
- Complicated effect in crisis times: everyone may “head simultaneously for the exit”
- Paradox in normal times… momentum in financial market may lead to opportunistic behavior of banks, yet same momentum driven markets would simultaneously have to impose discipline?

→ Market discipline effective for idiosyncratic differences between institutions, less for financial market driven strategies

Cost of capital fallacy

We do not need to like M&M, nor believe M&M has relevance to banking, but to deny that

"the cost of capital is affected by the risk that the capital is exposed to" is disturbing

Implications:

- Fixed cost of capital does not make sense
- Maximizing ROE fundamental violation of corporate finance theory
- Relationship activities suffer

…. No free lunches, yes self-fulfilling prophecy…

Complexity

- Simplifying structure of financial institutions of paramount importance for alignment market forces and prudential concerns
- But existing complexity itself makes it also difficult to act on structural measures.
- No readily available prescriptions on how to simplify
  - Difficult to grasp interlinkages and intralinkages

Dealing with complexity

i. Complex institutions difficult to manage and supervise (problem of opaqueness);

ii. A complex financial institution has many, difficult to discern linkages with the financial system at large; TBTF, too-interconnected-to-fail concerns;

iii. As a consequence systemic concerns might become more prominent;

iv. Complexity could put supervisors in a dependent position, e.g. how to intervene (timely)?

Dealing with complexity – 2

- Living will idea aimed at mitigating this
  - Only effective if dealt with ex ante
- How to disentangle businesses?
  - Separate legal structures, no recourse?
    - Would it work, and does market accept it?
  - Breaking-up banks? (Volcker Rule and beyond…)

Complexity fact of life?

Yes, but cannot not mean that we accept Allen Greenspan’s comment that the financial system is like Adam Smith’s invisible hand

…. some type of complex eco-system that is beyond anyone’s control or imagination, and is “unredeemably opaque” (*Financial Times*, March 31, 2011)

How to evaluate?

Resolving complexity to facilitate timely intervention. How does that relate to broader objectives:

- Mitigate contagion
- Safeguard core banking functions

And what can be said about

- Market conformity of regulation/supervision
  - Market forces often at odds with prudential objectives
- Costs of regulation and interventions

APPENDIX: More on marketability and changeability

- From finance literature we know that creating trading opportunities also has dark-side
  - Jacklin (1987) on Diamond-Dybvig (1983) liquidity transformation
  - Bhide (1993) on dark-side of liquidity
  - Boot-Gopalan-Thakor (2008) on desirable stability of shareholder base
- Banks increasingly subjected to volatility and momentum in financial markets
  - Bank-based systems more like market-based systems?
  - Stability bank-based systems affected more?

Marketability and stability of investment and relationship banks

First, investment banks (IBs)

- In past IBs were partnerships. Two characteristics:
  - Personal wealth tied up in IB
  - Cannot get full value of partnership share upon exit
- Move to shareholder structure
  - Marketability has created ‘star phenomenon’
  - Increasing emphasis on trading

→ stars go for personal franchise value rather than *institutional* franchise value (less prudent behavior)

Marketability and stability of investment and relationship banks (2)

Now relationship bank (RB)

- Does marketability relationship banks' assets create similar problems?
  - Less opaque assets reduce emphasis on *institutional* franchise value?

→Important issue now: stability of relationship bank threatened by

  - higher exposure to boom & bust nature of financial market;
  - 'star phenomenon' in the RB itself