The Financial Crisis and Bank Business Models

Conference on

European financial systems: In and Out of the crisis

UNIVERSITÀ DEGLI STUDI DI SIENA
FORD FOUNDATION
Siena, April 1-2, 2011

Philip Bourke,
Irish Banks' Professor of Banking and Finance,
UCD Michael Smurfit Graduate School of Management,
University College Dublin
Philip.bourke@ucd.ie

UCD Michael Smurfit Graduate Business School

100 YEARS 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**

- **Monetary Regulation**
- **Prudential Regulation**
- **Agency Issue** → **Moral Hazard**
- **Herding**

AGENCY INTERRELATIONSHIPS within THE BANKING SYSTEM

Electorate ⇨ Politicians ⇨ Central Bank

⇨ Banks

⇨ Depositors

⇨ Borrowers

Other Explanations

OVERHEATING

DOMINANT PERSONALITY

ILLUSORY DIVERSIFICATION

TREASURY AND FX EXPOSURES

INTERNAL CONTROL

Being English speaking or close?

MANAGEMENT

FRAUD

REMOTE LOCATION

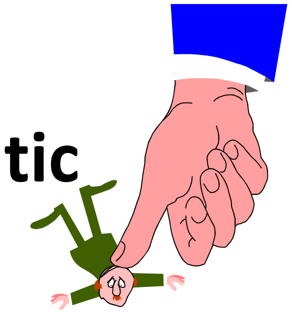
OVERHEATING

- Overlending into specific sectors.
- Frequently on assumption that fundamental economic laws have been repealed.
- For instance, lending to property on (unstated) assumption that property prices could not fall.
- LDC loans on assumption that countries could not become bankrupt.

EXAMPLES

- UK Banking collapse mid 1970s → property lending.
- Repeat in 1980s and 2000s
- Failure of Dutch mortgage lenders 1980
  → 40% fall in property values.
- Bank Of America
  - Agricultural lending in California.
  - LDC lending
    - assuming countries could not go bankrupt

DOMINANT PERSONALITY



- **One individual breaks down system of bureaucratic checks and balances.**
- **Makes credit decisions without reference to credit committees.**
- **Fraud sometimes involved.**
- **Connected lending.**

Very rare for a fast growing bank not to get into trouble
Even rarer if dominant individual is involved

EXAMPLES

- **First National Bank of San Diego - Smith**
- **Banco Ambrosiano - Calvi.**
- **Banesto - Conde**
- **Credit Lyonnais – Haberer**
- **RBS -Fred Goodwin**

ILLUSORY DIVERSIFICATION

- **Importance of diversification in loan portfolio**
- **Illusory diversification exists where diversification is more apparent than real**
- **All loans are subject to interest rate risk**

EXAMPLES:

- **Continental Illinois Bank**
- **LDC lending**

TREASURY

Interest & exchange rate management

Bets on interest rate, foreign exchange and commodity prices

Frequently ignoring efficient markets ideas

→ normal rate of return

EXAMPLES:

Rare for Treasury issues to kill a bank

- **Barings**
- **Midland Bank - interest rate exposure losses**
- **Alfirst**
- **Sécurité Générale**

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)

EQUITY ISSUE → SHARE PRICE FALLS 3%

CP/BOND/INSURANCE COMPANY LOAN → NO EFFECT

Bank Loan SHARE → PRICES RISE BY 2%

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