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Is There a Future for the Bank?

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In the good old days of plain vanilla finance, intermediaries were distinguished, and clearly *distinguishable*, between bank and non-bank intermediaries. The former, it was explained, were "special" in that they collected funds (mostly) in the form of short-term, sight money deposits, and lent them out (mostly) in the form of long-term, personal, non-marketable loans. The asymmetric time structure of deposits and loans, their asymmetric risk profile, and the role of deposits in the payment system, were not only matter of functional distinction with non-bank intermediaries; they were also the rationale for a special regulatory system reserved to banks. Typically, these were under the jurisdiction of central banks, rather than (or in addition to) that of security market or antitrust authorities. For about fifty years, from the '30s to the '80s of the 20th century, one cornerstone of bank regulation in almost all advanced countries was *tight separation* of banking from other large-scale financial market operations.

In spite of such a clear-cut institutional setup, its conceptual foundations were deemed unresolved and wanting. Was it special regulation imposed by central banks' need to control the payment system that made banks special intermediaries, or was it the other way round? A major contribution to clarification came from theoretical research on financial intermediation towards the end of the '70s. Those were the path-breaking years of the so-called "New theory of the bank" designed by scholars as Stiglitz, Weiss, Hellwig, Townsend, Diamond and others. Their innovation came from systematic application to financial markets of the Imperfect Information Hypothesis (IIH) that was reshaping many other fields of economic analysis. In finance, this hypothesis soon gained the status of an *alternative* paradigm with respect to the competing one based on the Efficient Market Hypothesis (EMH) formalized by Fama and others mainly at Chicago.

In a nutshell, the thrust of the new view was that banks are special because they manage financial transactions largely affected by particular risks that are quite different in nature with respect to the more familiar, well-behaved, statistical risks considered in the EMH and mastered by standard financial instruments. The focus was shifted onto what bankers would call "counterparty risk", that is, *idiosyncratic risk* arising from a *bilateral relationship* with an *individual borrower*. The source of these risks was identified in a particular manifestation of imperfect information, namely asymmetric information (AI).

Under AI, the outcome of a loan depends on unobservable characteristics or actions of the lender. The latter may have an incentive to exploit AI to gain a profit at the expense of the lender. Hence, the risk of a personal loan is not the same risk as that of a security traded on large anonymous markets. In particular, AI risks 1) are not subject to large-number statistical laws, whereas 2) they are *endogenous* to the originating transaction in that they can be higher or lower depending on 1) the way in which the transaction is designed, 2) the amount of resources and skills that the lender invests into *screening, monitoring and auditing* each and all its counterparties.

The outstanding result of the new approach to bank theory was a complete, elegant and self-contained explanation of the reason why banks do what they do (or are supposed to do) and why they are special. It was in fact demonstrated that the optimal solution to control for AI risks in terms of *market allocative efficiency* would require a specialized intermediary that invests in information extraction activities and combines long-term, personal, non-marketable loans ("standard debt contracts", SDCs) with sight deposits. In the lack of all this, several serious market failures would arise, whether in the form of excess lending to unprofitable borrowers or of rationing of profitable borrowers. Consequently, the conclusion was that special regulation was warranted because banks are indeed special. Ironically, this marvellous theoretical construction was completed - and crowned by a couple of Nobel prizes - while governments and monetary authorities were dismantling the time-honoured bank laws thus paving the way to the new era of all-purpose financial entities.

After about a quarter of century, the distinction between bank and non-bank intermediaries seems still in place. If I leave my money with a bank branch in the street I think I am doing something different than buying shares in a pension fund or a life insurance plan. I think that the bank branch in the street is in a different business than the pension fund or the insurance company, that it follows different aims and obeys different laws and rules, and that my money with the bank will be employed, and possibly returned to me with an interest, in a different way. Am I right? Probably I am not.

Today, the bank branch in the street is most probably a terminal money collector of a financial entity which even official authorities are unable to name. The European Central Bank in its official documents has invented the acronym LCBGs: Large and Complex Banking Groups (!) I find that "financial conglomerates" is a more vivid term. These are the outcome of the deregulation process recalled above. Their most remarkable features are

· wide-scope function and product diversification: retail banking, investment banking, insurance services; production, placement and distribution of a variety of financial instruments, simple and structured

· coexistence of market and non-market instruments on both sides of their balance sheet

· strategic pursuit of large globalized dimension and operation scale

· governance structure of large public companies with sharp separation between ownership and control

If we look at the balance sheets of major financial conglomerates we see a few significant regularities

· a high share of marketable financial assets with respect to direct loans (more than 40%)

· large recourse to short-term marketable liabilities with respect to deposits

· high returns from market transactions *vis-à-vis* low direct intermediation margins

· high leverage (beyond 30)

· heavy personnel costs, low dividends, strong growth of dimension and of stock-market value (a triad which hints at what may have been the balancing point among the interests of shareholders, high-rank personnel, and managers)

These are the entities that are in the eye of the storm of the crisis, indeed the originators-and-distributors of the crisis. By and large, financial conglomerates appear to be engaged in making money through financial trading by means of others' money. This may be a legitimate money-making activity and a good idea for incumbents. Yet the rest of society is also legitimately concerned that the amazing mass of funds mobilized by these conglomerates is also allocated efficiently for economic growth and welfare (so that profits are commensurate to this service). The blind faith professed in the Greenspan Era that there was no such a concern relied on the popular jingle of the EMH: they have all the right information, they know what they are doing, if they make profits it's because they are using money in the best way for the economy too.

Alas, as explained above this kind of reasoning does not apply under the IIH. In fact, the awakening from the Greenspan Era has brutally demonstrated that for financial markets to do their job well it is not sufficient to let smart people seek high profits by buying low and selling high. Under the IIH, what is good for financiers may not be good for society - just the opposite of the mantra of the Greenspan Era. Financial efficiency needs someone who actively takes care of screening, monitoring and auditing final users of funds. This is what banks have been doing for centuries, and that now seems jeopardized by the profit-seeking strategies of financial conglomerates.

If we go back to where all begun, we can see an adamantine manifestation of what the IIH and the New theory of the bank would predict to happen if "true" bank intermediation disappeared. Large-scale securitization of personal loans not only was badly engineered and managed: it was fundamentally, conceptually flawed. It was based on the faulty idea that AI risks, which are inherent in personal loans as explained above, could be treated as diversifiable, insurable and marketable risks. The idea of substituting SDCs with CDOs and economizing on information costs and other burdens related to traditional management of personal loans was obviously embraced enthusiastically, and in fact it contributed to boost skyrocketing profits of financial conglomerates. However, these have come at the expense of the efficient allocation of funds.

Now the question is: Is the securitization of banking the dissolution of banking? This question is crucial for the future of our financial systems after the crisis. In fact, the dissolution of banking would represent a colossal market failure, which would deprive the economy of a fundamental allocation mechanism. I am talking of a market failure because the phenomena under consideration are largely determined by spontaneous forces of which the financial conglomerates are the forerunners. In fact, the securitization of banking is not confined in the Unites States, but it is spreading all over the global financial system. It is telling that even continental Europe (and most remarkably Germany) which for a while lulled herself with the idea of "being different" and hence immune, has now discovered how vulnerable her banking systems were to the contagion of the US model of securitized banking. A most powerful driver of this diffusion process is just competition. It is clear that competition has squeezed margins in all traditional banking activities. If "true" banking turns out to be too heavy a burden in the race to keep up with competitors engaged in securitized banking, well, good-bye to "true" banking.

As is well-known, a market failure calls for public policy to intervene. The intellectual and ideological climate now seems favourable to deep reforms and re-regulations of financial systems. However, the issue of the future of the bank (of what banks should do) does not seem well focussed. Neither proposals for dimensional limitations of financial conglomerates, nor stricter risk-based capital requirements and leverage limits, that are now at the centre of the stage, have direct bearing upon the tendency towards the dissolution of banking. More to the point would be the quest for reintroduction of separation of commercial banks (or of their activities) from other financial intermediaries (or their activities). Given the tendencies described above, it is no surprise that this proposal seems bound to fall apart. The drawbacks and inefficiencies of old-style banking systems cannot be denied. However, the debate seems biased in that those drawbacks are compared with the alleged efficient setup guaranteed by financial conglomerates that is arguably non-existent. As is now clear, we can only choose between different inefficiencies and more modestly seek to avoid the worst.