The business of banking

Oct 28th 1999
From The Economist print edition

Banks have been at the heart of economic activity for eight centuries. In this, the second of our schools briefs on the world of finance, we explain why banks evolved, how they function, what they do, and the challenges they face

WHEN asked why he had robbed a bank, Willie Sutton, a 19th-century American outlaw, replied: "Because that's where the money is." His reasoning is hard to fault: since modern banking emerged in 12th-century Genoa, banks and money have gone hand in hand.

Banks are still pre-eminent in the financial system, although other financial intermediaries are growing in importance. First, they are vital to economic activity, because they reallocate money, or credit, from savers, who have a temporary surplus of it, to borrowers, who can make better use of it.

Second, banks are at the heart of the clearing system. By collaborating to clear payments, they help individuals and firms fulfil transactions. Payments can take the form of money orders, cheques or regular transfers, such as standing orders and direct-debit mandates.

Banks take in money as deposits, on which they sometimes pay interest, and then lend it to borrowers, who use it to finance investment or consumption. They also borrow money in other ways, generally from other banks in what is called the interbank market. They make profits on the difference, called the margin or the spread, between interest paid and received. As this spread has been driven down by better information and the increasing sophistication of capital markets, banks have tried to boost their profits with fee businesses, such as selling mutual funds. Such income now accounts for 40% of bank profits in America.

Deposits are banks' liabilities. They come in two forms: current accounts (in America, checking accounts), on which cheques can be drawn and on which funds are payable immediately on demand; and deposit or savings accounts. Some deposit accounts have notice periods before money can be withdrawn: these are known as time deposits or notice accounts. The interest rate paid on such accounts is generally higher than on demand deposits, from which money can be immediately withdrawn.

Banks' assets also range between short-term credit, such as overdrafts or credit lines, which can be called in by the bank at little notice, and longer-term loans, for example to buy a house, or capital equipment, which may be repaid over tens of years. Most of a bank's liabilities have a shorter maturity than its assets.

There is, therefore, a mismatch between the two. This leads to problems if depositors become so worried about the quality of a bank's lending book that they demand their savings back. Although some overdrafts or credit lines can easily be called in, longer-term loans are much less liquid. This "maturity transformation" can cause a bank to fail.

A more common danger is credit risk: the possibility that borrowers will be unable to repay their loans. This risk tends to mount in periods of prosperity, when banks relax their lending criteria, only to become apparent when recession strikes. In the late 1980s, for example, Japanese banks, seduced by the country's apparent economic invincibility, lent masses of money to high-risk firms, many of which later went bust. Some banks followed them into bankruptcy; the rest are still hobbled.

A third threat to banks is interest-rate risk. This is the possibility that a bank will pay more interest on deposits than it is able to charge for loans. It exists because interest on loans is often set at a fixed rate, whereas rates on deposits are generally variable. This disparity destroyed much of America's savings-and-loan (thrifts) industry. When interest rates rose sharply in 1979 the S&Ls found themselves paying depositors more than they were earning on their loans. The government eventually had to bail out or close much of the industry.

One way around this is to lend at variable or floating rates, so as to match floating-rate deposits. However, borrowers often prefer fixed-rate debt, as it makes their own interest payments predictable. More recently, banks and borrowers have been able to "swap" fixed-rate assets for floating ones in the interest-rate swap market.

Minding the bank

Because banks provide credit and operate the payments system, their failure can have a more damaging effect on the economy than the collapse of other businesses. Hence governments pay particular attention to the regulation of banks. Individual banks have reserve requirements; that is, they must hold a proportion of their deposits at the central bank, where they are safe and immediately accessible. The central bank typically pays little or, in America, no interest on these reserves. However it can charge interest on its loans, which is one way in which the banking system pays for its own regulation.

As a second cushion against a liquidity crisis, the central bank acts as lender of last resort. That is, when it worries that solvent banks might struggle to raise money, it will step in and provide finance itself. America's Federal Reserve did this after the 1987 stockmarket crash. Ten years later the Bank of Japan did the same because it thought that the difficulties the country's banks had in raising money were only temporary.

Another way in which regulators have tried to keep banks' heads above water is to force them to match a proportion of their risky assets (ie, loans) with capital, in the form of equity or retained earnings. In 1988 bank regulators from the richest countries agreed that the capital of internationally active banks should, with a few variations, amount to at least 8% of the value of their risky assets. This agreement, called the Basle Accord, is being revised, largely because the original makes only crude distinctions between loans' different levels of risk.

It is not just the failure of individual banks that gives regulators sleepless nights. The collapse of one bank can spread trouble throughout the financial system as depositors from other, healthy, banks suddenly fear for their money. Regulators step in because they want to prevent a collapse of the entire system.

Governments try to minimise the risk of such failure in several ways. One is to impose harsher regulation on banks than on other sorts of companies; often, the regulator is the central bank. Another tack is to try to prevent runs on banks in the first place. Following the collapse of a third of all American banks in 1930-33, the government set up an insurance scheme under which it guaranteed to repay depositors, up to a certain limit, in the event of bank failure.

Following America's lead, other countries have also introduced deposit-guarantee schemes. Even where they have not, depositors often assume that there is an implicit guarantee, because the government will step in rather than risk a collapse of the whole system. In this decade, the Japanese government went to the extreme of guaranteeing all lenders (not just depositors) to the country's biggest banks until the end of the century.

Some argue that these guarantees make bank failures more likely, because they encourage depositors to be indifferent to the riskiness of banks' lending. Moreover, as banks get bigger, they are also likely to conclude that they are "too big to fail", which is an incentive to take more risk. Both are a form of moral hazard.

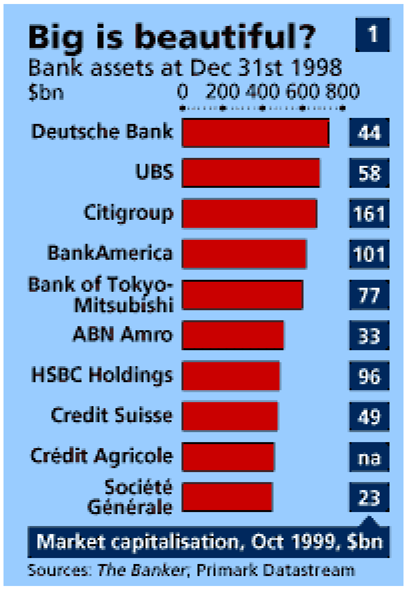
To combat moral hazard, regulators try to be ambiguous about how big is too big, and to restrict the amount of insurance they provide. In recent years, none of these measures has prevented ill-advised lending by banks around the world. Failures include the excessive loans of American banks to Latin America in the 1980s; and banking crises in Japan, Scandinavia and East Asia.

In many countries, governments have responded to emergencies by nationalising the worst banks, often pledging to inject capital, take on their dud loans, and reprivatise them. This is fine in theory, but in practice it often distorts the market for the remaining privately owned banks by keeping too many banks in business and by allowing nationalised banks with the benefit of a government guarantee to borrow more cheaply.

A mixed bank

Another difficulty increasingly faced by both regulators and banks is the plethora of institutions that conduct banking business. In Germany, for example, less than a third of deposits by value are held within the privately owned banking sector. Retail banks—those that do business mainly with individuals—often compete with mutual or state-owned institutions. Often, such institutions were founded to provide mortgage financing. Spain has its *cajas*—savings banks owned by regional governments; France, the Netherlands and Japan all have agricultural co-operative banks that were created to finance farmers.

Active mutual and state-owned banks can lower the profitability of privately owned banks, since they tend to care less about profits. In France and Germany, banks' returns are far below those in Britain or America. As a result, banks' assets—the traditional measure of size—are often unrelated to the value of the banks on the stockmarket (see chart 1).



Increased competition in lending has meant that over the past couple of decades banks have expanded their lines of business. In Europe, in particular, a new type of banking, called *bancassurance* (*Allfinanz* in Germany) has grown up. This is a fusion of banking and other financial services and involves banks selling life assurance and long-term savings products, such as pensions, as well as taking traditional bank deposits.

Banks that combine all of these elements are known as universal banks. Germany's big three Frankfurt-based banks, Deutsche, Dresdner and Commerzbank, are all universal banks, as is HSBC, the Anglo-Chinese giant. So, arguably, is America's Citigroup, which is the product of a merger between Citibank's global-banking business and the Travelers insurance group.

Banking is a lot messier than it was. In Britain, two big supermarket chains, Tesco and Sainsburys, now take deposits. Many non-banking firms, such as General Motors, also now provide credit, although regulators are less worried about institutions lending money than about those collecting it. American credit-card operators, such as Capital One and MBNA, have entered the market, using the techniques of database marketing to identify the most lucrative customers. This has caused established lenders to trim their rates. Last year the Prudential, Britain's biggest life insurer, launched a telephone and Internet bank, called Egg, which has lured a large amount of money away from traditional banks.

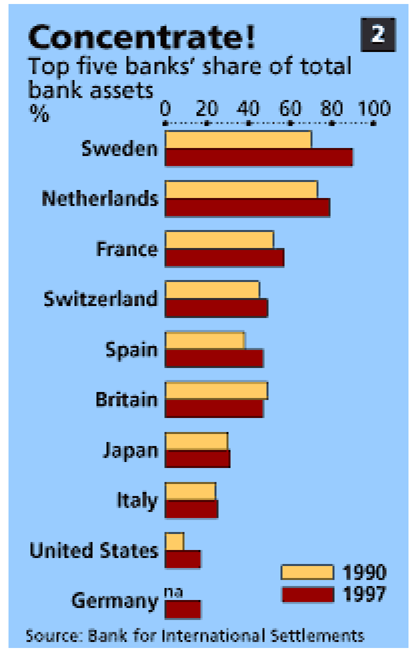
Worse still for traditional banks, many companies in America raise money by selling bonds rather than by borrowing from banks, a process called disintermediation. In America, the share of business finance that comes from banks has shrunk from 59% in 1970 to 46% today. With the single market and the euro, European firms are increasingly following suit. This has benefited investment banks.

Investment banks, as distinct from ordinary "commercial" banks, help firms raise money in the capital markets, and advise them whether to finance themselves with debt or equity. They underwrite such issues by agreeing, often with other banks in a syndicate, to buy any unsold securities, and are paid a commission for this service. They provide a liquid market in securities, and (now less than in the past) invest their own capital, an activity known as proprietary trading. In addition to advising clients on raising finance, they also advise on mergers and acquisitions, usually their most lucrative work.

In America the Glass-Steagall Act has prevented commercial banks from acting as investment banks and also from underwriting insurance. Japan has a similar rule.

Although the act is now likely to be repealed in America, its effects have already been much weakened. Commercial banks have been able to underwrite some securities. Investment banks have offered services that look exactly like current accounts. Some now even offer credit cards.

As well as entering the investment-banking business, commercial banks have responded to increased competition by trying to cut costs. The way is being led by banks in America and Britain, where shareholders hold more sway, labour laws are less restrictive and deregulation is more advanced. They have merged, replaced costly branches with cheaper ones in supermarkets and such places, laid off expensive staff and moved processing to cheap "back-office" administration centres. Those that fail to get costs under control become the target of takeover bids. This is because it is easier to cut costs by buying a rival bank and eliminating overlapping branches and overheads. As chart 2 shows, this process has led to increased concentration in some banking markets around the world (in Britain the figures are distorted by the reclassification of many building societies as banks, thereby enlarging the banking market).

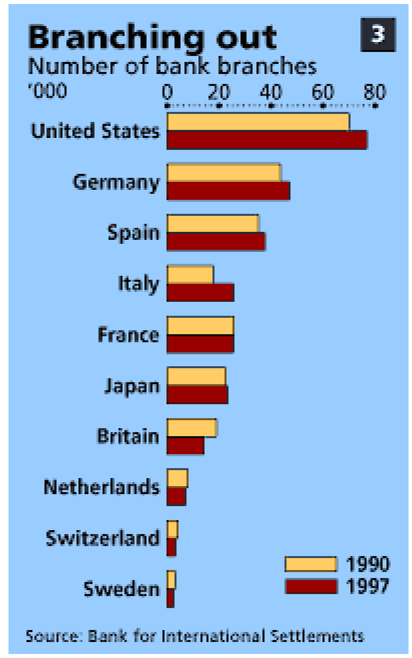


Rivals in other countries, especially in continental Europe and Asia, have found it difficult to cut labour costs. Until recently, they have tried to increase profits by lending more or by expanding the number of branches (see chart 3). However, thanks to the single market in financial services, European banks have tried to cut costs by merging, too. Since monetary union at the beginning of the year, the restructuring has gathered pace. In Japan, where consolidation has been painfully slow, banks are at last starting to do the same.

Credit online

Despite all the effort being made by banks to consolidate and cut costs, the advance of the Internet raises doubts over their long-term prospects. Without the expense of running branches, online banks have lower costs and can thus offer cheaper products or higher interest rates to depositors.

E-Loan, an American online bank, originally offered cheap mortgages; now it also offers cheap credit cards, car loans and small-business finance. Americans, tired of the tedious paperwork of writing cheques and reconciling bank accounts, are ready to relinquish such duties to the likes of paymybills.com. These services, which concentrate on the most profitable customers for each product, threaten to leave banks with the unprofitable rump of depositors and borrowers. Having seen share-trading move online more rapidly than many had expected, traditional banks are trying to come up with their own Internet strategy.



In the next phase of net banking, the Internet will be used by innovative financial firms to pool information about customers' entire financial affairs, including their non-bank products, such as mutual funds. This is an even greater danger to traditional banks, because it threatens to be better than the service they can provide offline. Future Willie Suttons may need a course in hacking: the money will be in the ether.