

The Role of Bank Business Models in the Financial Crisis

Conference on

Growth and Global Imbalances
Chinese and European approaches

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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??**

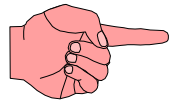
Are Banks Special

Eugene Fama

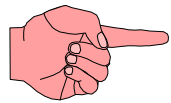
Bank's comparative advantage

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**