



THE FUTURE OF BANKING

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Banking in Iraq: The 21st Century Challenge

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INTRODUCTION

Without exception all the basic (traditional) functions of banks have been subjected to increased competition since the early 1980s. Banks are losing traditional monopolies and some of their historic competitive advantages. In effect, banks are losing their pre-dominant role as deposit takers and lenders to companies. Market pressures are eroding the market imperfections that gave rise to banks' comparative advantage in intermediation in capital markets. More especially, financial innovation and technology are reducing transactions and information costs. In addition, banks' own cost structures (including cost of capital) may also have eroded some of their comparative advantages. The underlying problem for banks is in essence a combination of lower entry barriers to banking and a trend towards the unbundling of financial instruments, which means that a wider range of firms can provide banking services. Banking has increasingly become a "do-it-yourself" activity for corporate entities. In this respect competition has become asymmetric in that non-financial companies are able to diversify into banking more readily and profitably than banks can diversify out of financial services. Thus, while retail stores can offer consumer loans, banks do not - as yet - sell frozen food or clothing.

If entry barriers are being lowered, and banking has become more competitive and yet exit barriers have not been lowered, there is a tendency for excess capacity to be created, which in turn increases the cost structure of the banking sector. The 1980s-1990s period has already proven that significant slices of banking business can be competed away relatively easily by the non-bank financial institutions, securities markets and corporate entities. Three means were generally employed: technology/innovation (e.g. computer-driven information systems); globalization (putting international pressures on local banking business); and deregulation (often forced by innovation and globalization, but always resulting in sharply increased competition). Accordingly the traditional role of banks as financial intermediaries is currently being undermined by the following developments:

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- Financial innovations are producing more complete and efficient capital markets and fewer market imperfections.
- Increased prudential requirements have made the costs of intermediation more expensive for banks. Non-banks often have greater portfolio flexibility in making markets in indirect securities.
- Technological improvements and financial innovation have lowered the entry costs into banking.
- "Unbundling" of financial instruments (e.g. the securitization of mortgages) has allowed corporate entities to involve themselves in significant parts of the intermediation process from which they were previously excluded. It has also meant that non-banks (e.g. supermarkets) have been able to challenge banks in their traditional markets, because: (i) they offer only a limited range of banking products (the profitable part); and (ii) are able to sub-contract some of the processes.
- Reduced transaction costs and lower information costs in capital markets have improved the competitive position of securities firms vis-à-vis banks.
- Asymmetric competition has increased from corporate entities that are exploiting their own client bases by offering all types of financial services. Corporate entities often operate in this field without any of the constraints typically applicable in banking.
- Technology has eroded the traditional bank monopoly of money transmission services, e.g. today many retailers are involved in the payments mechanism by means of credit cards.

Let us try and analyze the situation of the banking sector with that of the railroad. It has often been observed that railroad companies lost their dominating role in the American economy because they saw themselves in the railroad business rather than in transportation. Today, is something-similar happening to banks? A study commissioned by the Bankers' Roundtable in 2005 concluded, "Banking is essential to a modern economy; banks are not."

Are banks as we know them threatened to become second-rate institutions because they cannot keep up with regulatory changes, competition from non-banks, technology and institutional progress? This is the question we ought to be asking of ourselves.

TRANSFORMATION OF BANKING

The banking industry has undergone massive transformation due to deregulation and competition from non-banks in the last decade. In the near future, the shape and scope of commercial banks will look nothing like its past. For example, with the slow demise of Glass-Steagall Act (1933) in the USA, the separation between commercial and investment banks has become blurred. Several banks are now in the business of underwriting debt and equity offerings. Recent trends in regulation and product innovation by both commercial and investment banks ought to be studied carefully. This includes origination, underwriting, and distribution of new securities to the public.

Banks are not strictly about money. Banks are about information. They are information processing and control centers that adjust, coordinate and channel the shifting claims on society's pool of resources. In fulfilling these functions, banks, like all institutions, are based on a particular regulatory framework, information technology and economics. If the regulatory framework; technology and the economics change, the institutions must adjust too.

In the beginning, the information gathering technology of banking was based on personal knowledge based on proximity. To reduce risk, depositors and lenders alike had to know each other's personal and business reputation. Given the physical nature of money, they needed to be close to each other for transactions. These reasons led to localized banks, networked with each other.

Today, vastly more powerful information technologies than word-of-mouth have become available to the world of finance: high-capacity telecommunications links, powerful and interconnected computers, cheap storage, value-added data networks, unbreakable encryption, and much, much more. These technologies led to numerous changes:

- Internal management information systems permitted better control from a distance and enabled banks to grow in size, geographic reach, and scope of activities.
- Easy credit verification and billing made widespread credit card operations feasible.
- Electronic funds transfer led to vast money flows.
- The composition of bank employment changed.
- Direct payroll deposit systems made the electronic gathering of deposits possible.
- Automatic teller machines permitted banks to reconfigure branches. Whereas the average cost for a teller transaction is \$1.07, it is only \$0.27 for an ATM transaction.

THE FUTURE OF BANKS

One could imagine that all these changes strengthened banks by making them faster, smarter, broader, and more global. But this is not so. Even though banks have become bigger, they have been weakened. One of the major reasons is that the new technologies have accelerated the entry of rival institutions that were more adept in utilizing them. Today, American banks' share in borrowing has dropped from 36% in 1974 to less than 20%. For thrift institutions, it dropped from 21% in 1976 to less than 8% in 2004. Commercial banks' share of total financial intermediary assets dropped from a steady 40% in the 60s through 80s to below 30% in the latter half of the 1990s, the first time that deposits in non-banks were greater than in banks.

One major reason for the decline was the growth of alternative sources of funds. Information technology enabled investors to evaluate securities and to be reached directly by borrowers. Thus, commercial paper outstanding as a percentage of business loans rose from around 5% in the 1970s to above 35% in the 2000s. Computers could be used to evaluate credit risk by using various quantitative methods, and this made it possible for non-banks to transform loans into marketable securities. This technique of securitization by non-banks is now also moving to small business loans.

In response, banks increased non-lending activities. The share of their non-interest income rose, their commercial real estate loans; as a percentage of assets doubled. And they began to be heavily active in financial derivatives. Widespread derivatives markets were not possible without information technology; their complexity makes controls difficult, and this increased riskiness. It helped bring down the Baring and Daiwa banks, demonstrating the global nature of the problem. In non-lending activities, too, banks fell behind institutions without banking charters but with superior operational or technological ability. In credit card processing, banks lost all but 20% of the market to non-banks. Banks were slow in offering Electronic Data Interchange (EDI) services that standardized invoicing and payments for transactions. When EDI emerged outside of banks it reduced the need for bank intermediaries.

ATMs, too, proved a mixed blessing. The linkage of ATMs to banks declined: physically, over 45% of American ATMs are not located at banks anymore. As this reduction in physical presence continued, the banks' advantage of proximity declined. Customers deal with machines that are now interlinked by vast ATM networks, and care little about who is behind them -- a bank, a near-bank, a non-bank, or a distant bank. Institutionally, over 20,000 ATMs are operated by non-banks, and their share is increasing. ATMs led to a reduction in branches.

This retreat from brick-and-mortar has long-term effects on banks as organizations. In the past, the work process was organized such that the employees would come to the place where the information relevant to the business was present, physically or in the knowledge of their co-workers, and the customers would come to the employees. But this flow is being reversed as it is becoming much cheaper to move information than people. Therefore, data is moving to the employees, wherever they are; customers, too, are now everywhere. In the process, banks are gradually become virtual organizations -- networks of specialists sharing information, decentralized boutique operations interacting, and customers distributed around the globe, often equally virtual as the banks. Many employees are working at home or at far-away locations. Indeed, the concept of stable employment itself is changing to ad-hoc arrangements and to independent contractors working for multiple employers. For many tasks, these employees are now located at the lowest cost locations -- not Tokyo and New York but Manila and Bangalore.

By focusing on ATMs as teller-less branches, banks lost sight that these were merely one electronic form of customer interface, and a fairly inconvenient one at that. Thus, banks were unprepared for the emergence of terminals and network relations outside their control, as the Internet emerged as a locus of commercial activity in which vast numbers of customers are connected to a vast number of businesses, transacting with each other in increasingly secure and authenticated ways.

THE NEXT GENERATION OF MONEY

Even more radical will be the change in the nature of money, the banks' life-blood. Technology is leading to new types of money -- e-money, digital cash, cyber-dollars. Money has metamorphosed from store of value like a gold coin, to a physical token like a bank note, to a variety of payment vehicles, to a string of digital signals that are recognized as valid claims. Now, "smart" stored-value cards can receive, contain, and dispense these signals easily and securely, using one of several systems for encryption and authentication. These cards would be replenishable electronically from distance, even by wireless communication. They would create, in effect, a mobile, shirt pocket ATM. Old-fashioned money will still be around. But soon, "digital wallets" will become prevalent that permit electronic money, as well as specialized money -- cash that earns interest, cash that is conditional, i.e., usable only on certain items or in certain locations, or "closed cash" that functions only within certain institutions. Who would dispense e-cash, and in what currencies? Various financial institutions are likely to issue their own money or near-money. Some of these currencies would be pegged to real resources such as oil, while others might be fixed to some official currency, and still others would be based on the issuers' reputation. In such a fashion, parallel private currencies would emerge.

Private e-money raises many questions.

- Is e-money a "natural" monopoly? Or will there be competing monies? Should governments issue e-money? Will it license issuers and/or standardize the terms of e-cash?
- How can one deal with the tax fraud, money laundering, and criminal activities that are facilitated by untraceable and ubiquitous e-cash? Even in legitimate transactions, to who are taxes owed?

- How does one protect individual accounts (and indeed the entire system) against attack, loss, crash, intrusion, counterfeiting, unauthorized use, or default? Could or should risky users be excluded? What is the nature of liability?
- How does the emergence of private e-money affect the stability of the monetary system? If it creates "open money" of stateless currencies that may be accepted around the globe but are responsible to no one, governments could lose control over the money supply and monetary policy. Even where some countries set rules, such as by licensing who could issue e-money, there would be incentives for others to become e-money havens.
- Similarly, how would one deal with inflation? Or, more accurately, with the multiple inflation rates of the various monies? Most likely, different people could pick the particular currency that best reflects their preferred inflation rate.

Perhaps the main question for banks is: Who will supply electronic money and authenticate it to its recipients? Will it be banks or non-banks? Would they be licensed and regulated? So far, a variety of entrants into electronic money have emerged proposing various techniques. One first observation is that many of the companies involved are not banks. Banks taking an initiative are less than a handful of big banks, from among the thousands of American banks, or they are the banking industry's credit-card organizations, whose interests may well not be to make cash transactions convenient relative to the profitable credit-card operations.

Still more critical for banks' long term role is an important fact: with e-cash one can bypass banks. Individuals and firms can pay directly into each others' e-money wallets or stored-value smart cards. Such transactions would be like handing over cash among individuals. Why then have a middleman, the bank, for such transactions? And, why have transfer intermediaries among banks, such as correspondent banks, and clearing networks such as SWIFT, or central banks?

Banks have no obvious advantages in the e-money business over other providers, such as network operators or over computer network platforms. It was for related reasons that Citicorp furiously dropped AT&T as a telephone service provider when it entered the credit card business, and that many banks strongly opposed the planned acquisition by Microsoft, of Intuit, whose Quicken software could have helped divert transactions to Microsoft's new MSN network.

The latter example shows that banks are beginning to appeal to government to protect them by evoking various public interest, consumer protection, and competitive equity rationales to exclude non-bank competition in electronic money, or to control it tightly. But in a dynamic global economy with distance-insensitive communications, protective regulation is not sustainable in the long-run.

BANKS AS FINANCIAL SYSTEM INTEGRATORS

In 1815, the Rothschild bank in London used a carrier pigeon to obtain the critical news of Napoleon's defeat at Waterloo. Even for the time, this was a backward communications technology: the French already had a "semaphore" signaling telegraph that could transmit coded messages at a speed of over 500 miles per hour.

Birds worked for Rothschild. But luck and pluck cannot be the business strategy for today's banking industry. Their self-image notwithstanding, banks are not near the leading edge of information technology applications. Their information technology investments are lagging. According to one study, the cost of systems and hardware of American banks will have to double, from 10 to 20% of total non-interest costs. And there is very little R&D by banks. Yet, information technology and the pace of change will accelerate, if anything. In the past, a gradual change was acceptable because banks competed largely with other banks, which acted at a similar pace. Those banks that were faster adaptors of technology, like Citicorp or

State Street Bank, could forge ahead. By now, many non-bank institutions are active on banks' turf. They are often more innovative, usually less regulated, and, with cheap electronic communications, more global.

How then can banks attract and retain business and how can they differentiate themselves from each other? There is a way for banks to create an opportunity out of a problem. Electronics is a two-way street. A bank can use information technology to create a full service customer relationship. They must create an integrated financial value-added platform that combines convenient transaction, information, and communications. Through these platforms, banks can become financial shopping malls, perhaps with several anchor services of their own, but mostly occupied by many financial service boutiques provided by other specialized companies. The bank's function is to link them up, provide a brand identity, control risk, and assure quality. This is a systems' integrator function, and it must be clearly distinguished from the provision of the service modules themselves. A successful systems' integrator must use the best and most efficient modules, without favoring its own operations, if it wants to prevail against competitors.

The specialized functions would be a wide potpourri: credit cards, e-money, commercial credit, payments, tax returns, insurance, health care claims, invoicing and collection, retirement accounts, data bases, record and book keeping, point-of-sale services, card authorization, encryption, custody, mortgages, portfolio accounting, budgeting, etc., etc.

Thus, banks could be at the center of electronic commerce for their customers, and benefit from the transformation of what today are cash transactions into electronic ones.

In short, banks must become financial systems integrators. They must integrate all the various financial services of the customer. Their orientation would be customer and relationship based, not account oriented. They have awesome amounts of information on their customers' transactions, which they could, with the proper protection of privacy, use to serve customers in an integrated fashion. They could play a vastly increased role in the financial transactions of large customers, too. These banking customers change, too. They also become decentralized and often virtual organizations, for reasons similar to those of banks.

OTHER NEW OPPORTUNITIES FOR BANKS

The need for a paradigm shift from a bank centric capital market system to a stock market centric system is becoming clear and more or less universally accepted in economies around the world. Therefore, capital markets have to be expanded to provide for a broader institutional infrastructure. In addition, the various institutions in the new paradigm have to offer broader flexibility as to their basic role, objectives, risk propensity, investment strategy, investment flexibility, regulatory restrictions, and level of involvement. The flexibility has been limited in prevailing bank-centric systems due to limited infrastructure.

Therefore, what are the emerging new opportunities for banks and development finance institutions as we move towards a new paradigm of financial sector development? (Note: Regulatory requirements may require for some of these activities to be undertaken separately from the existing legal entity)

- Bank Affiliated Investment Bankers- Origination, underwriting, and distribution of new securities to the public. Providing institutional infrastructure to promote orderly trading. Engaging in broker-dealer operations, liquidity and asset management, clearing and settlement functions, custody services, portfolio accounting, investment management, trustee services, securitization, etc.
- Investing in Market Infrastructure- exchanges, depositories, credit rating agencies, registries, etc.

- Bank Affiliated Venture Capitalist – Focus on providing capital to early stage high growth firms, assist in corporate restructuring (to include restructuring of turnaround companies and privatized firms) and assist in re-capitalization of existing corporate clients seeking to raise equity.

CONCLUSIONS

The threats to traditional banks may not happen overnight, but they will surely arrive. People often overestimate the impact of change in the short term, but they also underestimate it in the long term. They recall that earlier promises about home banking and the cashless society failed to materialize, and they now believe that even a vastly more effective interactive medium will meet the same fate, forever. Those who hold these views will pay for them, eventually.

This is the most exciting period the world of finance has ever seen. There are tremendous opportunities for those who succeed in marrying finance with information technology, and technology with relationship management. Yes, banks have more opportunities than ever before, but their customers opportunities have grown even more, and with it, the customers' bargaining strength. Yes, there is a chance for some of those dinosaurs, as Bill Gates has dismissively called banks. There is a chance for some of them to quickly seize on this opportunity and take a giant leap forward. For those who fail to be in the forefront, there will be trying times ahead.

As we begin to ponder on a way forward, let us make sure that we keep these global developments in mind and that we move towards building and Iraqi banking industry that is well-positioned for the 21st century. The *Iraqi Banking and Finance Conference* is a starting point for us to collectively define a vision for this very critical support sector of the economy.