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The long-term role of non-traditional banking in profitability and risk profiles: Evidence from a panel of U.S. banking institutions

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A B S T R A C T

The goal of this empirical study is to identify empirically and on a panel basis how non-traditional bank activities affect directly the profitability and risk profiles of the financial institutions involved in such activities. Through a dataset that covers 1725 U.S. financial institutions involved in non-traditional bank activities spanning the period 2000–2013 and the methodology of panel cointegration, the empirical findings document that non-traditional bank activities exert a positive effect on both the profitability and the insolvency risk. The results could be important for regulators given they could serve as a pre-warning signal that sends a clear message to regulators about the potential systemic risk that exists within the financial markets.

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1. Introduction

The introduction of the U.S. Gramm-Leach-Bliley Act of 1999 eliminated any functional barriers between commercial and investment bank activities, allowing the U.S. banks to offer a full range of financial services. At the same time, the adoption of the securitization model in which banks allocate their funding not only to lending activities, but also to asset securitization, provided the field for additional funding mechanisms, known as non-traditional items. As a result, the new banking model

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gave rise to a reduced need of traditional bank services, to the presence of higher systematic risks, and to the need of more effective regulation (Cetorelli and Peristiani, 2012; Claessens and Ratnovski, 2013). Gambacorta and van Rixtel (2013) argue that the recent financial crisis triggered a reassessment of the argument that non-traditional bank activities can offer value added to banks' profitability.

The non-traditional bank activities, such as items associated with securitization, investment banking, advisory fees, venture capital, and non-hedging derivatives, are totally differentiated from traditional bank activities, i.e. deposit taking and lending functioning (Pozsar et al., 2010), while they can be a substantial source of systemic risk, both directly and through their interconnectedness with the traditional bank activities. Higher levels of diversifications make the bank system too complex and, thus, substantial agency problems may arise.

The goal of this work is to shed light on the empirical identification about how non-traditional activities conducted by U.S. banks influence their profitability-risk trade-off. The novelties of the paper come to fill certain voids in the relevant literature, such as: (i) by considering a very recent period – including the financial crisis 2007 event – that no other study has done it before, (ii) a number of robustness empirical tests that sharpen the interpretation of our findings and lend clear support to our baseline results, and (iii) by providing the extent to which disaggregated non-traditional bank activities contribute to profitability and risk profiles.

The empirical findings provide evidence that such non-traditional bank activities exert a positive effect on both the profitability and the risk profiles of banking institutions involved in such activities. In terms of the disaggregation framework, the findings show that there is not any unified behavior across all the components of such non-traditional bank activities. For a number of components, related to mortgage-backed securities, there is a statistically significant value-creating and risk-increasing empirical finding, albeit it is smaller vis-à-vis the aggregate outcome, implying that these components require banks to take relatively long-term stakes in assets. These findings highlight the need of regulatory bodies to better monitor the market that ignited the financial crisis event.

This paper is related to the corporate finance literature and to the role of diversification costs emerging from non-traditional activities along with the effects on the regular bank system's valuations and risk profiles. This literature has exemplified the limited diversification gains in terms of higher profitability and reduced risk for those institutions that attempt to diversify their portfolios of activities, i.e. traditional and non-traditional activities, while a number of studies in the literature supports the view that banks must focus on those lines of business that their management has a comparative advantage over alternative activities. The main strand in this literature focuses on the regulatory arbitrage obtained by the business of non-traditional banking (Acharya et al., 2013). According to this view, banks conduct non-traditional bank activities so as to circumvent regulatory capital requirements which might increase the fragility and the collapse of the system. This paper is related to this strand in the sense that it also examines the impact of such non-traditional bank activities on the fragility of the banking system.

Section 2 provides a review of the literature of non-traditional bank activities, while Section 3 discusses the data and presents the empirical analysis. Finally, concluding remarks and policy implications are provided in section 4.

2. Literature review

One main strand of the literature highlights the need of the financial institutions to be involved in non-traditional bank activities due to the presence of gains. Myers and Rajan (1998) offer the differences in asset mix as an explanation for the tendency of banking institutions to be involved in activities away from the traditional bank zone, differences that motivate bank managers to trade against banks' interests. Cornett et al. (2002) and Deng et al. (2007) present evidence that non-traditional bank activities are expected to reduce the cost of debt, while Mester (2010) supports that banks experience high economies of scale and benefits by expanding their portfolio of activities into non-traditional items, while any attempt to restrain them from doing so would have unintended consequences.

By contrast, in the strand of the literature that documents the negative side of non-traditional bank activities, a large number of studies have stressed the negative side of non-traditional bank activities. More specifically, Stiroh (2004a,b) and Stiroh and Rumble (2006) investigate whether small U.S. banks

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