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Universal banking and financial architecture[☆]

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ABSTRACT

Discussions of systemic risk after the financial crisis of 2007–09 have focused heavily on so-called “systemically important financial institutions” (SIFIs) a cohort of financial firms that is almost exclusively (but not necessarily) comprised of large, complex and heavily interconnected financial conglomerates. This paper considers the economic and strategic drivers of SIFIs – if such institutions are a key source of systemic risk, it is important to understand how and why they get that way. The paper then sets forth a public-interest perspective on the financial architecture by setting out key benchmarks – static and dynamic efficiency, stability and robustness, and competitiveness – and the tradeoffs that exist between them, and examines how SIFIs can support or detract from these benchmarks. If SIFIs are to be subject to much sharper prudential regulation, its impact must be calibrated against systemic performance benchmarks. Finally, the paper focuses on some of the major regulatory initiatives following the 2007–09 financial crisis, and in particular the US Dodd–Frank legislation of 2010, in terms of their possible impact on business models of SIFIs. The paper concludes that improving the financial architecture in a disciplined, consistent, internationally coordinated and sustained manner with a firm eye to the public interest should ultimately be centered on market discipline. By being forced to pay a significant price for the negative externalities SIFIs generate – in the form of systemic risk – managers and boards will have to draw their own conclusions regarding optimum institutional strategy and structure in the context of the microeconomics and industrial organization of global financial intermediation. If this fails, constraints on their size, complexity and interconnectedness will be a major part of the policy reaction to the next financial crisis.

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In the aftermath of the financial crisis of 2007–09 and the inevitable regulatory response that is continuing to evolve in various parts of the world, renewed attention is being devoted to the institutional structure of financial intermediation. Is bigger better? Is broader better? What about geographic reach? Would the US have been better off not repealing in 1999 the functional constraints imposed in 1933 in terms of the fragility of its financial system under stress conditions? Are the continental Europeans justified in clinging to a universal banking model which dominates the financial landscape, even as the UK engages in active debate about whether its financial conglomerates ought to be broken-up? And what about the systemic risk properties of such firms and the competitive advantages they derive from being too big or too complex

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or too interconnected to fail. Passage of the 2010 Dodd–Frank Act in the United States, the Basle-3 capital and liquidity rules, and regulatory initiatives in the United Kingdom, continental Europe and elsewhere have moved the debate along, and repeatedly come back to the linkage between organizational structure of financial firms and systemic risk – either as “manufacturers” of systemic risk or as a key issue in crisis-resolution after systemic damage materializes.

Such issues take on ever greater importance in the context of globalized financial markets, where different strategic structures compete with one another, as well as international financial firms competing in various local markets around the world. In the absence of agreement on the role of organizational structure and institutional constraints in dealing with systemic risk, global coordination and assignment of regulatory responsibility becomes even more difficult. Structural issues also take on importance in emerging markets as they consider alternative strategic models for their financial architecture – and in many cases seem to be embracing the financial conglomerate model.

This paper begins with a simple flow of funds model of the financial system, breaking-out the key functions that are performed by various kinds of institutions in the intermediation, maturity

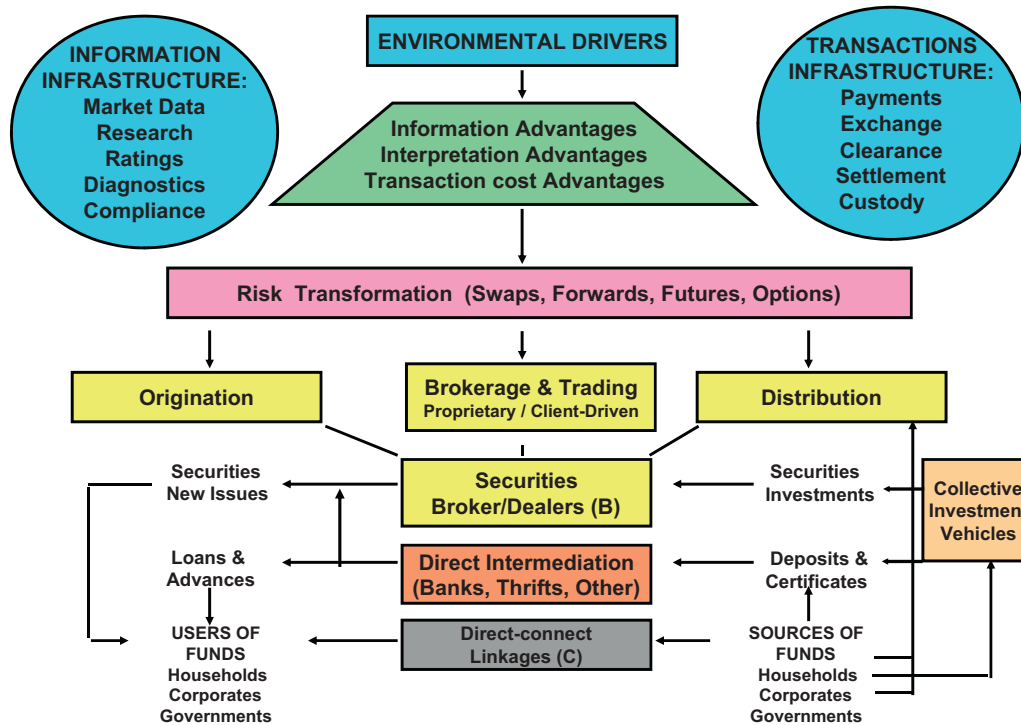


Exhibit 1. Financial intermediation road-map.

transformation and risk allocation process. Section 2 of the paper examines institutional comparative advantage in carrying out the key financial intermediation functions identified on the template. Section 3 applies a simple three-dimensional matrix to the industrial organization options facing financial intermediaries. Section 4 is a discussion of the sources of institutional comparative advantage and raises central questions of scale and scope in financial intermediation. Section 5 considers policy implications and the role of the institutional structure of financial firms in efforts to achieve a sound balance between financial efficiency, innovation, competitiveness and systemic robustness. Section 6 concludes.

1. Financial intermediation dynamics

The central component of any model of a modern financial system is the nature of the conduits through which the financial assets of the ultimate savers flow to the liabilities of the ultimate users of finance, both within and between national economies. This involves alternative and competing modes of financial intermediation, or ‘contracting’, between counterparties in financial transactions. A guide to thinking about financial contracting and the role of financial institutions and markets is summarized in Exhibit 1. The diagram depicts the financial process (flow-of-funds) among the different sectors of the economy in terms of underlying environmental and regulatory determinants or drivers as well as the generic advantages needed to profit from three primary linkages:

- *Fully intermediated financial flows.* Savings (the ultimate sources of funds in financial systems) may be held in the form of deposits or alternative types of claims issued by commercial banks, savings organizations, insurance companies or other types of financial institutions that finance themselves by placing their liabilities directly with the general public. Financial institutions ultimately use these funds to purchase assets issued by

non-financial entities such as households, firms and governments. This is denoted as linkage (A) in Exhibit 1.

- *Investment banking and securitized intermediation.* Savings may be allocated directly or indirectly via fiduciaries and collective investment vehicles, to the purchase of securities publicly issued and sold by various public- and private- sector organizations in the domestic and international financial markets. This is denoted as linkage (B) in Exhibit 1.
- *Direct-connect mechanisms between ultimate borrowers and lenders.* Savings surpluses may be allocated to borrowers through various kinds of direct-sale mechanisms, such as private placements, usually involving fiduciaries – including hedge funds and private equity funds – as intermediaries. This is denoted as linkage (C) in Exhibit 1.

Ultimate users of funds comprise the same three segments of the economy – the household or consumer sector, the business sector and the government sector.

- Consumers may finance purchases by means of personal loans from banks or by loans secured by purchased assets (hire-purchase or installment loans). These may appear on the asset side of the balance sheets of credit institutions for the duration of the respective loan contracts on a revolving basis, or they may be sold off into the financial market in the form various kinds of securities backed by consumer credit receivables.
- Corporations may borrow from banks in the form of unsecured or asset-backed straight or revolving credit facilities and/or may sell debt obligations (for example commercial paper, receivables financing, fixed-income securities of various types) or equities directly into the financial market.
- Governments may likewise borrow from credit institutions (sovereign borrowing) or issue securities directly.

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