THE FUTURE OF MULTINATIONAL BANKING

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Summary

To provide a useful analysis of the frequently-shifting world of multinational banks, we develop a series of models to capture the key drivers of change.

The dominating change is technology. The models first describe how technical progress that affects all market players may change the balance among the market players. These players are the banks engaged in broker functions, processing and selling information but not taking principal positions in transactions, and the qualitative asset transformers that do take principal positions with their clients.

Overall the reduced cost of technology tends to encourage the growth of brokers and reduce the role of QATs.

If technical progress is more specific to individual banks, less certain and more dynamic, the impact of change becomes less obvious. With uncertain gains from research and development and no learning from existing “sales,” potential market entrants invest more in R&D than incumbents and provide competition to incumbents. If banks learn by doing then incumbents may have an advantage that can grow with time. Potential entrants to the market are less threatening. Adoption of new technologies may be slower.
1. Introduction

If multinational banks (MNBs) have a future then it must be because they are able to undertake economic functions more successfully than other economic entities. This is especially true for MNBs because they do not typically enjoy direct financial support from governments or other organizations that would be in a position to subsidize activities that regularly destroy economic value. More specifically, an MNB that consistently lost money over a long period of time would be unlikely to survive in the open markets in which it operates. The same statement is true for the class of economic entities we consider to be MNBs.

In this entry we consider the analytic basis for an economy to have a preference for financial intermediation through specialized organizations. The role of international financial regulatory authorities is not examined here in detail (see The Regulation of International Banking and Capital Markets) but the authorities do have a role. If regulatory authorities find the development of MNBs acts against national interests, we anticipate a bleak future for the MNBs even if their efficiency in a free market is clearly demonstrable. A regulatory authority taking the view that MNBs contributed to the financial fragility of its own economy, for example, would seek to limit the activities of MNBs. There have been recent instances of these limitations proposed and implemented, especially following apparent financial crises.

This discussion is the foundation for considering the future of multinational financial intermediaries themselves. We explore if the international market is in the process of evolving particular biases towards the use of intermediated debt as a form of financing, thereby supporting the continuation of MNBs. There is a vigorous debate over this process and we review both sides of the debate.

A key insight that has emerged in the on-going discussion about MNBs is the distinction between the functions undertaken by an MNB and its organizational form. A strong tendency in recent writings about financial intermediation is that “banking will survive, but banks may not.” That is, the functions undertaken by banks such as deposit-taking and loan-making, will be necessary parts of the capitalist system. The institutional arrangement, however, of resource-transfer may not be stable or enduring, especially in the international context. It may not be necessary to have a single entity involved with every stage from the creation of instruments to allow deposits to take place through to the origination of loans and the continued monitoring and holding of the loans to maturity. Further, risk management associated with the resource-transfer process need not be provided by the same institution, nor by a single external organization.

2. The Changing Paradigm for Multinational Banking

A traditional paradigm for intermediation places banks and other financial intermediaries at the center of a process of resource allocation. Households may possess low and high levels of wealth. Firms may be large or small, and possess different investment opportunities but in general they have little wealth. The high-wealth households, typically considered to be surplus units in the economy in the sense that
they earn more income than they spend, seek opportunities to invest their surpluses. The firms are usually deficit units, spending more than they own in funds.

Financial intermediaries provide the households with their investment opportunities by gathering the funds of myriad households and ensuring their allocation to firms that have the knowledge but not the funds for investment that creates real wealth. The successful firms return funds with an excess through the financial intermediaries to the households to reward the latter for their willingness to part with the funds for a period of time. In the process, the financial intermediaries extract a fee for the service they provide. The fee comes from the excess return on funds created by the firms.

Because the financial intermediaries continue to undertake this task of resource allocation from surplus to deficit units, they become efficient and can lower the transactions costs they impose. They also provide information to the market about the investment opportunities, and from their experience can estimate risks of new investment opportunities better than the other units or sectors of the economy. The intermediaries are also the most significant players in the financial markets for bonds and equities, since their risk evaluation knowledge allows them to price these assets more accurately than the less-informed or practiced firms or households.

In the international economic situation, the process is similar. The surplus units (ultimate lenders) and deficit units (ultimate borrowers) may be in different countries, and the information may be more difficult to obtain because of the international transfers; but the underlying process is no different from that in the domestic market. The close connection of the intermediaries with the international financial markets is even more strongly defined in the international context. (See Globalization of the International Finance System).

It has been observed in recent years from the 1980s that a shift in the balance of activities has occurred in the relationships outlined above. Households increasingly deal with intermediaries, as long as we include in this grouping insurance companies and pension funds. Small firms also maintain their relationships with financial intermediaries. One significant change has been that large firms have more frequently gone directly to the financial markets to obtain external financing, using their own risk profiles to support their borrowing at low interest rates. Financial intermediaries have kept a role in the decision making of the large firms, but it has related more to financial advice associated with the original issue of debt instruments than with the direct issue of the debt.

A second major shift in the role of the financial intermediaries has been their increased activity in risk management for firms and households. The apparent increase in financial asset price volatility from the 1970s encouraged the growth of financial risk management tools offered mainly by the financial intermediaries that had skills in creating and pricing these tools.

We need to develop our understanding of why these shifts in the conventional role of the financial intermediary have occurred, and what they may mean specifically for multinational banks. To do so we revisit what the finance literature has identified as the
key traditional differences between financial intermediary functions and those offered by financial markets trading securities at arm’s-length prices.

There are three differences between financial markets and financial intermediaries in the traditional paradigm of the economy. First, markets tend to have lower costs for trading standard securities whereas intermediaries can create securities tailored to the needs of individual investors or firms. The standard securities can be more easily traded in a secondary market due to their nature and hence are regarded as being more “liquid” than the securities specifically designed for single customers. A trade-off emerges then between liquidity and customization.

Second, markets tend to be more competitive and provide their financial services at lower costs. Financial intermediaries can exercise greater control over their customers because they possess valuable information about their customers. The intermediaries have obtained this information from the close working relationship that they develop with their customers. It is very costly for customers in such a relationship to leave it and go to another financial intermediary and start the whole process of relationship development again. This is known as a “lock-in” effect if the financial intermediary then uses the close relationship to extract rents. Further, the existence of a secondary market for the standard securities provides a larger pool of resources on which the intermediaries, firms and households can draw for investment purposes. This lowers the cost of transacting in the investment market.

Third, the execution of transactions, monitoring of investments and acquisition of information may exhibit increasing returns to scale. There are fixed costs involved in each of these activities. A specialist institution may be able to defray these costs over large-scale operations so that it can reduce the per unit expense for investors. For example, the acquisition of information may have a fixed cost; but an intermediary that learns this information can then distribute it at close to zero marginal cost to many customers. A financial intermediary could also package risk associated with its customers’ investments in efficient ways for them because it is familiar with their individual information sets and attitudes to risk. Markets cannot offer such risk management opportunities because they deal in average attitudes and overall information.

Financial markets, both domestic and international, have grown in sophistication over the period from the 1960s. This has threatened the relative importance of some of the conventional roles of intermediaries, but has provided some new opportunities. Hedging instruments have often become more flexible in addressing the concerns of individuals in the financial market place but they have also tended to become more complex to manage. The strategies for using these instruments have also become more elaborate. The combination of swaps and options, for example, has provided considerable challenges for those required to price them for trade.

While tangible transaction costs such as fees for existing services may have declined, some information costs have increased. Evaluation of complex financial instruments has even developed its own alternative methods of analysis. (See Evolution of Global Markets and Instruments). Intermediaries that are frequently dealing with such complex
instruments can offer their expertise to clients for a fee. The growth in market complexity and depth has been echoed by a shift in the focus of work by the financial intermediaries, not by a decline in their work.

There is theoretical support for this development. Research on financial market structure in the 1980s showed convincingly that the cost of information would drive a wedge between the efficient social outcomes (the “core” of the economy) and what had been considered the benchmark optimum of multi-period sequential Nash equilibrium allocations of goods and services. The wedge was created by the assumption that people in the core undertook the allocations of goods and services costlessly. The Nash equilibrium assumed limited communication and so made it costly to enter into binding agreements for production and employment. The role of information was more important than had been thought. The Nash equilibrium did allow some communication prior to commitment to production and sales, but it suggested that at least one way to establish this communication was through the creation of intermediaries. Since this was only one way to introduce the limited communication, it clearly showed that the Nash equilibrium was not unique. The summary point from this literature has been that we should not be surprised by the emergence of intermediaries with a significant role in providing improved communications of consumption and production desires within an economy. The empirical findings for the shift in the role of financial intermediaries towards having a larger role in communications and information processing are well supported by theory.

Bibliography


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Biographical Sketch

Christopher Adam is currently Professor of Finance at the Australian Graduate School of Management, and Associate Dean-Faculty for the AGSM. The new AGSM was created in 1999 as a joint venture between The Graduate School of Business at The University of Sydney and the graduate management school of the University of New South Wales. Chris came to The Graduate School of Business at Sydney University in 1992 as its Professor of Finance. He became the Acting Director of The GSB in 1998 on the retirement of the Foundation Director, as well as continuing in the role of Head of the Department of Management Studies for The University. From 1989 to 1992 Chris was Associate Dean for Academic Affairs and Associate Professor of Economics at Bond University. Before being invited to become a member of the Bond University foundation faculty in 1989, Chris taught and researched at the Australian Graduate School of Management in the University of New South Wales. He had come to that School in 1977 as one of its inaugural faculty members. Chris holds a Bachelor of Economics degree with First Class Honours from the University of Western Australia (1974) and earned his MA and PhD degrees in Economics from Harvard University in the USA (1977). He has been an editor of the *Australian Journal of Management*, the *Bond Management Review* and the *Journal of Applied Finance and Investment*. He was a book review editor for *The Economic Record*. Chris has also been Director of the AGSM MBA Program (1984-87, and 1999-2000); and, as foundation Director of the Bond University MBA, established this degree for the University. He has also been Director of the MBA Program at The University of Sydney.