Would Banks, King of Capital, Ever Be Dethroned?

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Walter Bagehot, in his book "Lombard Street: a description of the money market," quoting Ricardo, said, "The distinctive function of the banker 'begins as soon as he uses the money of others'; as long as he uses his own money, he is only a capitalist." [1] This argument appears to be outdated as institutional investors such as hedge funds, mutual funds, pensions, private equity funds, and others also use other people's money.

Nonetheless, Ricardo's remark remains profoundly valid because these modern institutions are in sharp contrast to banks in that they are not responsible for other people's money losses and are entitled to receive management fees regardless of their performance. Meanwhile, banks are discharged with judiciary duties [2] and take both losses and gains when taking deposits and lending out [3]. Subsequently, banks still hold a firm grip of power on the front of using the money of others. However, the 2008 global financial crisis (GFC) represented a pivotal moment in which the crown of banks was in peril as Fintech started to grow exponentially.

Figure: Headquarters of the Swiss National Bank in Bern, by Baikonur (CC-BY-SA-3.0).

Fintech, the interaction between finance and technology, describes new technology that seeks to improve and automate the delivery and use of financial services [4]. It is ranged from peer-to-peer lending, crowdfunding, virtual money, and robo-advisor to cross-border payment. At its core, Fintech is utilized to help companies, business owners, and consumers better manage their financial operations, processes, and lives by utilizing specialized software and algorithms used on computers and smartphones [5]. The concept is not novel as banks have always been long renowned for their heavy investment in adopting state-of-art technologies in operations. Nevertheless, after the GFC, while banks were busy dealing with numerous new regulations and fine and punishment settlements post-crisis, they unintentionally created room for other players with the most game-changing technological innovations to tap into unexplored or underexplored financial market segments. As a result, this led the concept of Fintech to move from the wings to the center stage in the field of finance.

At first glance, banks seemed not to be threatened for many reasons. First, they have a long history and trust with their customers, which have shaped people's consumption mindsets and patterns of financial services for centuries [6]. Shifting their mindsets and patterns requires a substantial amount of time and resources. Second, they have deeper pockets and big data. And most importantly, banks control the back-end of finance, the "rails" of the industry, consisting of the established infrastructure that banks use to interact and transact with each other, such as clearing (NSCC), payment (ACH), and messaging (SWIFT) systems which need to be used by many Fintech firms. (*Note: NSCC: National Securities Clearing Corporation; ACH: Automated clearing house; SWIFT: The Society for Worldwide Interbank Financial Telecommunication.) With their capability, banks can invest in and/or acquire Fintech firms. Thus, the scale of the threat to the banking industry can be summed up as follows: "The aim is to inflict death by a thousand cuts. […] Fintech start-ups are nimble piranhas, each focusing on a small part of a bank's business model to attack" [7].

The battle, however, appears to occur a paradigm shift in international payment when a few Fintech giants, such as US-based Ripple and Australia-based Novatti, have grown to deliver real-time global payments without tying up capital in destination markets. With disruptive technologies and a network of more than 100 financial institutions worldwide, Ripple of the US can settle cross-border payments in a few seconds instead of around 24 to 48 hours as in the legacy technology-based system by banks [8]. On top of that, during the pandemic, many central banks went far as to intervene directly in credit markets, weakening the role of commercial banks. As an example, the scale of the quantitative easing by the Fed, to the tune of US$23.5 trillion, surpasses any other interventions in its history [3].

With the threats from Fintech firms and regulators, would banks ever be dethroned from the crown? The answer to this question yet remains to be examined. Nonetheless, it is worth studying because it would define the future of banking.

References

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