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Perspectives

## Where the Financial Services Industry Goes from Here

By [Knowledge@Wharton](#) | Posted: 09-16-14 | 11:25 AM | [Email Article](#)

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*In the book *A New Era in Banking: The Landscape After the Battle*, Angel Berges, Mauro F. Guillén, Juan Pedro Moreno and Emilio Ontiveros examine the opportunities and challenges for the banking industry following the financial crisis that began in 2007. The following review explores the book's takeaways for banking leaders.*

*Knowledge@Wharton also recently had an opportunity to speak with Guillen and Moreno about their new book. Watch the video above.*

"The financial sector in general, and banks in particular, will never be the same," proclaims *A New Era of Banking*. The book is written by Angel Berges, professor of finance and international management at Universidad Autonoma, Madrid, and professor of finance at AFI-Escuela de Finanzas; [Mauro F. Guillén](#), Wharton management professor and director of the Joseph H. Lauder Institute of the University of Pennsylvania; Juan Pedro Moreno, managing director of Accenture's global banking industry practice, and Emilio Ontiveros, economic and business administration professor at the Universidad Autonoma de Madrid. They are referring to the impact on the industry of the catastrophic financial crisis, which began in 2007 and came close to destroying the Western world's financial system.

A team of writers from *Bloomberg News* estimated in 2010 that the total cost of outlays and commitments by U.S. taxpayers of stabilizing the crisis was \$12.8 trillion, almost as much as U.S. Gross Domestic Product for a year. The Federal Reserve Bank, the powerful U.S. central bank, will not provide details and, despite three court rulings, continues to refuse to do so, arguing that it would exacerbate the crisis.

These crises — and the shenanigans that caused them — forced U.S. taxpayers to assume the risk of funding rescues of the financial system and other major institutions. The resulting panic and outrage, the authors write, resulted in banks losing the public's trust and the goodwill of policymakers and regulators.

"Many have come to perceive banks not as institutions that manage risks but as entities that create or amplify them," the authors write.

As bad as the impact was on the U.S. and Western Europe, however, the news wasn't entirely disastrous. Banks in Latin America and Asia will benefit over time by demographic growth and technological changes, changing the basic structure of banking. Emerging economies, once the world's borrowers, will increasingly become lenders.

In their book, the authors lay out how the nature of competition has changed banking since the financial crisis began and as the banking system has stabilized. In developed economies, for example, there is an excess of banks. Such overbanking will result in forcing breakups in size and complexity. Banks will have to shed assets and business lines that are less profitable than the equity required to build and sustain them.

Banking growth in emerging markets is now being driven by young customers, who trust banks less and technology more Twitter, the authors say. Customer loyalty, especially by the young, was scant even before the financial crisis. Technology will make competition more flexible and will make switching between banks easier. "Relationship" banking, the traditional form of banking, will increasingly give way to data-driven information about customers.

As with other technologies, emerging markets are leapfrogging traditional, slow-growing methods with new technologies in banking. These reduce customer loyalty in favor of speed, utility and practicality. They also have given way to demand for a stakeholder society. No longer will shareholder value alone be enough. Customers will increasingly demand consideration of employees, suppliers, philanthropy and other constituencies to improve value creation. That became even more of an issue with the financial crisis and the perception of excessive executive compensation and a lack of corporate governance.

The authors offer a long and useful list of ways in which banks and institutions in developed countries can evolve, including instituting policies that can potentially rebuild customer loyalty and trust, creating stakeholder systems, increasing corporate transparency and, for big banks especially, building comprehensive corporate governance systems. They also offer means to assuage the public and governmental impression that bankers abused their financial privileges and perks and complacently expected taxpayers to pick up the bill.

The authors also lay out equally impressive solutions in which developed countries can use their rapidly growing technologies, such as mobility and connectivity, to reduce customers' dependence on bricks-and-mortar banking and their inclination to switch banks for efficiency. At the heart of these suggestions is the use of the smartphone, which can be used for information, research, retail transactions, bill paying and other means, which the younger generation expect and routinely take advantage of.

### **The Impact of the 'Great Recession'**

There is no question that the "Great Recession" of 2008 was the worst crisis the Western world has faced since the Great Depression of the 1930s. The financial world came very close to a total collapse. A great many homeowners suffered foreclosure as a result of predatory lending, many others simply walked away from their mortgages and an enormous number of homes lost value, even falling to below their mortgage value. Thousands of investors lost value in their stock market investments while others lost the value of complex financial instruments.

And yet, there have been a number of financial scandals before then. In the 1980s, for example, the deregulation of the Savings & Loans industry gave them many of the powers of banks without the regulations of banks. Many S&Ls, also known as "thrifts," borrowed money for short terms but loaned funds out for long terms meaning that depositors could not necessarily get their money back. When it was over, some 750 of 4,000 S&Ls had closed and taxpayers had lost more than \$124 billion in bailing out the thrifts.

During that same period, investment firms engaged in leveraged buyouts (LBO deals), which allowed small companies to buy larger ones using high-yield debt, known as junk bonds. The debt was repaid with the assets of the acquired company. The companies so acquired were often stripped of their assets, which were then sold,

leaving little more than a shell behind. The largest example of an LBO was the purchase in 1988 of RJR Nabisco. The LBO was set off by RJR Nabisco's chief executive, who proposed to take the company private. Other takeover firms quickly jumped in. When the fight ended, Kohlberg, Kravis Roberts & Co won with a bid of \$25 billion. It was the largest LBO of its time, but it was only one of several takeovers that took place during the go-go 1980s.

Even now that the Great Recession has stabilized, questionable practices continue. One is shadow banking. These are unregulated institutions, which borrow and lend money. Included among them are hedge funds, private equity funds, special purpose entities, asset-backed commercial paper and other structured investment vehicles. A 2013 academic paper notes that in 2007, the 11 largest national shadow banking systems in the world totaled \$50 trillion in size. Even after surviving the financial crisis, shadow banking totaled more than \$100 trillion in 2012. The risk has multiplied.

The newest source of risk is high-frequency trading. These controversial financial instruments — machine-based program trading systems — are complex algorithms that use computers and microwave relays to shave tenths of seconds to execute millions of trades a day. Estimates indicate that about half of all market trades are high-frequency trades.

In their effort to improve the banking system, Berges, Guillén, Moreno and Ontiveros could focus in future studies on these kinds of risks — past or present. They have done a very good job of explaining how to improve the world's financial system by the use of speed and technology. They should also focus on risks that face us in the future. Those risks will continue to exist. The authors are right in predicting a new era in banking. Most of that era will improve our lives. But without ways in which to develop new methods to regulate the system, we will always be at risk of loss, while institutions profit.

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