We Do not Need Giant Banks: Internet Technology Will Break Up Big Bank Monopoly?

Peer-to-Peer Lending and Crowd-Funding Have the Power to Change Finance

By Washington's Blog
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We don't need giant banks.

As we noted in July, small banks do much more lending than big banks:

> Do we need to keep the TBTFs to make sure that loans are made?
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> Nope.
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> USA Today points out:
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>> Banks that received Federal assistance during the financial crisis reduced lending more aggressively and gave bigger pay raises to employees than institutions that didn't get aid, a USA TODAY/American University review found.
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>> The amount of loans outstanding to businesses and individuals fell 9.1% for the 12 months ending Sept. 30, 2009, at banks that participated in TARP compared with a 6.2% drop at banks that didn't.
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> Dennis Santiago – CEO and Managing Director of Institutional Risk Analytics (Chris Whalen's company) – notes:
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>> The really shocking numbers are in the unused line of credit commitments of banks to U.S. business. This is the canary number I like to look at because it is a direct expression of banking and finance confidence in Main Street industry. It's gone from $92 billion in Dec -2007 to just $24 billion as of Sep-2010. More importantly, the vast majority of this contraction of credit availability to American industry has been by the larger banks, C&I LOC from $87B down to $18.8B by the institutions with assets over $10B. Poof!
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> Fortune reports that smaller banks are stepping in to fill the lending void left by the giant banks' current hesitancy to make loans. Indeed, the article points out that the only reason that smaller banks haven't been able to expand and thrive is that the too-big-to-fails have decreased competition:

> Growth for the nation's smaller banks represents a reversal of trends from the last twenty years, when the biggest banks got much bigger and many of the smallest players were gobbled up or driven under…
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> As big banks struggle to find a way forward and rising loan losses threaten to punish poorly run banks of all sizes, smaller but well capitalized institutions have a long-awaited chance to expand.

BusinessWeek notes:

> As big banks struggle, community banks are stepping in to offer loans and lines of credit to small business owners…
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> At a congressional hearing on small business and the economic recovery earlier this month, economist Paul Merski, of the Independent Community Bankers of America, a Washington (D.C.) trade group, told lawmakers that community banks make 20% of all small-business loans, even though they represent only about 12% of all bank assets. Furthermore, he said that about 50% of all small-business loans under $100,000 are made by community banks…
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> Indeed, for the past two years, small-business lending among community banks has grown at a faster rate than from larger institutions, according to Aite Group, a Boston banking consultancy. "Community banks are quickly taking on more market share not only from the top five banks but from some of the regional banks," says Christine Barry, Aite's research director. "They are focusing more attention on small businesses than before. They are seeing revenue opportunities and deploying the right solutions in place to serve these customers."

Fed Governor Daniel K. Tarullo said:

> The importance of traditional financial intermediation services, and hence of the smaller banks that typically specialize in providing those services, tends to increase during times of financial stress. Indeed, the crisis has highlighted the important continuing role of community banks…
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> For example, while the number of credit unions has declined by 42 percent since 1989, credit union deposits have more than quadrupled, and credit unions have increased their share of national deposits from 4.7 percent to 8.5 percent. In addition, some credit unions have shifted from the traditional membership based on a common interest to membership that encompasses anyone who lives or works within one or more local banking markets. In the last few years, some credit unions have also moved beyond their traditional focus on consumer services to provide services to small businesses, increasing the extent to which they compete with community banks.

Thomas M. Hoenig pointed out in a speech at a U.S. Chamber of Commerce summit in Washington:

> During the recent financial crisis, losses quickly depleted the capital of these large, over-leveraged companies. As expected, these firms were rescued using government funds from the Troubled Asset Relief Program (TARP). The result was an immediate reduction in lending to Main Street, as the financial institutions tried to rebuild their capital. Although these institutions have raised substantial amounts of new capital, much of it has been used to repay the TARP funds instead of supporting new lending.

On the other hand, Hoenig pointed out:

> In 2009, 45 percent of banks with assets under $1 billion increased their business lending.

45% is about 45% morethan the amount of increased lending by the too big to fails.

Indeed, some very smart people say that the big banks aren't really focusing as much on the lending business as smaller banks.

Specifically since Glass-Steagall was repealed in 1999, the giant banks have made much of their money in trading assets, securities, derivatives and other speculative bets, the banks' own paper and securities, and in other money-making activities which have nothing to do with traditional depository functions.

Now that the economy has crashed, the big banks are making very few loans to consumers or small businesses because they still have trillions in bad derivatives gambling debts to pay off, and so they are only loaning to the biggest players and those who don't really need credit in the first place. See this and this.

So we don't really need these giant gamblers. We don't really need JP Morgan, Citi, Bank of America, Goldman Sachs or Morgan Stanley. What we need are dedicated lenders.

The Fortune article discussed above points out that the banking giants are not necessarily more efficient than smaller banks:

> The largest banks often don't show the greatest efficiency. This now seems unsurprising given the deep problems that the biggest institutions have faced over the past year.
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> "They actually experience diseconomies of scale," Narter wrote of the biggest banks. "There are so many large autonomous divisions of the bank that the complexity of connecting them overwhelms the advantage of size."

And Governor Tarullo points out some of the benefits of small community banks over the giant banks:

> Many community banks have thrived, in large part because their local presence and personal interactions give them an advantage in meeting the financial needs of many households, small

> > businesses, and agricultural firms. Their business model is based on an important economic explanation of the role of financial intermediaries–to develop and apply expertise that allows a lender to make better judgments about the creditworthiness of potential borrowers than could be made by a potential lender with less information about the borrowers.
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> > A small, but growing, body of research suggests that the financial services provided by large banks are less-than-perfect substitutes for those provided by community banks.
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> It is simply not true that we need the mega-banks. In fact, as many top economists and financial analysts have said, the "too big to fails" are actually stifling competition from smaller lenders and credit unions, and dragging the entire economy down into a black hole.

As we pointed out last year in a post entitled "Do We Need Banks, Or Can We Cut Out the Middleman?", the Internet may render *all* traditional banks unnecessary:

> The big banks do very little traditional banking. Most of their business is from financial speculation. For example, less than 10% of Bank of America's assets come from traditional banking deposits.
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> Time Magazine gave some historical perspective in 1993:
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> > What would happen to the U.S. economy if all its commercial banks suddenly closed their doors? Throughout most of American history, the answer would have been a disaster of epic proportions, akin to the Depression wrought by the chain-reaction bank failures in the early 1930s. But [today] the startling answer is that a shutdown by banks might be far from cataclysmic.***
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> > Who really needs banks these days? Hardly anyone, it turns out. While banks once dominated business lending, today nearly 80% of all such loans come from nonbank lenders like life insurers, brokerage firms and finance companies. Banks used to be the only source of money in town. Now businesses and individuals can write checks on their insurance companies, get a loan from a pension fund, and deposit paychecks in a money-market account with a brokerage firm. "It is possible for banks to die and still have a vibrant economy," says Edward Furash, a Washington banks consultant.
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> Yahoo Finance says we don't need banks since we have peer to peer capacity:
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> > There was a time when banks were the obvious place to go if you needed a loan, whether as an individual or business. However, with the economic difficulties of the past few years, they have become increasingly reticent about handing over any of their cash, despite Government intervention.
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> > Thankfully a new way of borrowing money has come to the fore — peer-to-peer lending — and it offers an opportunity for both borrowers and investors alike.

In 2007, Ode provided a great historical perspective of the issue:

> Banks' shortcomings have been recognized for centuries—and for centuries, groups of people have been organizing themselves to take advantage of alternatives. In the mid-19th century, a pair of German economists extended the growing idea of "co-operative societies" to credit. By 1864, a group of farmers had joined together to secure loans for livestock, seeds and farming equipment, forming one of the first credit unions, a co-operative, community-based banking model that still thrives.
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> More recently, in the last 30 years, the rise of microcredit has brought many small loans to people in poor countries and rural areas who had no access to traditional banks or could not present the kind of bona fides a bank requires. Microcredit has sparked a revolution in the international development community, proving the existence of plenty of credit-worthy people who are simply overlooked by traditional banks.
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> Combine the principles of microfinance and online social networking, and you get a new phenomenon: peer-to-peer lending, or social lending as it's sometimes called. In the last two years, more than a dozen websites have been launched to connect borrowers and lenders—no banks required.
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> Peer-to-peer lending appeals to lots of people. Americans already lend more than $89 billion to friends and family every year, according to Federal Reserve estimates. Nearly 75 percent of Britons said they'd consider using a peer-to-peer website to borrow or lend, and some estimates suggest the global market for peer-to-peer lending will grow to more than $5 billion by 2010.
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> While cutting out the middleman may be instinctively attractive to many people, it can have an economic advantage too. Compared to credit cards, peer-to-peer lending offers borrowers really attractive interest rates—often half what they might expect to pay Visa or MasterCard.
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> And peer loans are often structured more fairly. A debt can be paid off in installments, unlike with credit cards, which can trap borrowers under debt that snowballs every month. For lenders too, these loans offer a higher rate of return than what they can earn on savings accounts. Interest is important, say small lenders.
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> It is that goal—getting capital to people who need it at reasonable rates—that creates a strong sense of purpose and community in social lending. The sites promote personal ties between lenders and borrowers. And with the global reach of the Internet, borrowers no longer need to know someone with money to secure a loan. By the same token, lenders often feel they're helping a real person get through a bad patch or realize a dream.
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> Traditional bankers have a hard time seeing it that way. "They're dumbfounded," says George Hofheimer, chief research officer for

> the Filene Research Institute, a Wisconsin firm that studies consumer finance. "Why would anyone lend money to strangers?" The banking establishment, after all, considers itself expert at evaluating the risks involved in lending money. Social lenders concede that point. Lending is risky, and peer-to-peer sites often use the same tools—credit reports, income verification—to judge how stable a borrower is.
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> But banks also have a vested interest in remaining the middleman, and they've never been quick to adapt to change. Industry observers point to the success of the online bank ING Direct, which caught brick-and-mortar banks unprepared, and say peer-to-peer lenders may have a similar effect.

Open Democracy points outs [the two main banking functions – which could hypothetically be provided by third parties]:

> A lot of people are busy trying to figure out how to make banks better. There is anger about what has gone on and puzzlement about the apparent inability of anyone to start doing something about it. [W]e seem to be frozen in a technical discussion of bank separation, capital adequacy, product authorisation, remuneration and incentives, or taxation. All worthwhile subjects in their way, but guaranteed to keep the sans-culottes at home.
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> So let's ask another question. Why do we need banks – what are they for?
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> Loosely speaking, banks [through the Federal Reserve system] make money. Banks are not the only entities that do this, but they are the ones whose purpose it is to do this.
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> The other thing that banks (but again, not only banks) do, is to record and execute monetary transactions. In return for transaction fees, they hold and manipulate the data relating to people's accounts with them. We are all either debtors or creditors of banks and we need to have accounts at banks because the trust system that banks represent is the required medium for nearly all financial transactions. When I transfer a sum of money to you, I simply instruct my bank to initiate a sequence of entries in its books and those of your bank.
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> In 1976 F.A. Hayek published a short book called Denationalisation of Money. It can be downloaded free from the link. Hayek conceived the essay as a response to the endemic debasement of currency by states addicted to inflation. He argued that legal tender laws should be abolished and that private institutions should be allowed to issue currencies in their own name.
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> Hayek understood that technology existed or would soon exist to price and complete even small everyday transactions real-time in several currencies at once and he expected that data on bank

capital and money issuance could be gathered and disseminated without trouble.

But back in 1976 there was no alternative technical model of how monetary transactions might be carried out, and so whilst Hayek foresaw a world without central banks, it was impossible to conceive of one without banks. Nevertheless, it's an elegant and in some ways compelling idea that addresses the problem of monetary discipline where states or central banks may be unwilling or unable to exercise control and private credit creators have every incentive to issue as much of this publicly guaranteed money as they can.

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Which brings us to Bitcoin. Launched a couple of years ago and still in its infancy, it calls itself a peer-to-peer virtual currency. This means that instead of a bank, the collective network of users maintains a complete encrypted record of bitcoin ("BTC") transactions and how many BTC each user has. Payments involve a public-private key exchange so that only valid identities can participate and each BTC can only be transmitted once. Because both parties have the complete data set, no external trust system is required. It's a mechanism that removes the need for us to transact through banks.

At a macro level, the total number of BTCs in issue will approach a known fixed limit at a geometrically reducing rate (as in Zeno's paradox, never quite reaching it) and expansion of the money supply takes place through the collective computation of the network. The advantages are claimed to be resilience, safety, absence of transaction costs, decentralisation, international acceptance, and no debasement. Because no physical currency is involved, arbitrarily small decimal units of BTC are possible. If convenient, BTC units could be subdivided or consolidated merely by a network-agreed software change. The monetary authority is therefore the network of users and their machines, which once it has reached a reasonable size becomes hard for even a super-computer user to dominate.

Even if we no longer need banks to store and handle our money, the BTC system, like any other currency, allows credit creation through fractional reserve banking. The BTC money supply could therefore exceed the number of BTCs in issue. However, without a BTC central bank, the imprudent lender may well go bust. It will be interesting to see how regulators deal with mainstream banks that acquire significant assets and liabilities in BTC. They might outlaw the BTC operations of regulated entities, but could they really close down an unregulated global user network?

It remains to be seen whether this is an advance of democratic self-determination. At this stage I would be optimistic, especially if Bitcoin's proof-of-concept encourages others to develop distinct, communicating architectures that would create not just a digital currency but a digital currency exchange. There are some fascinating possibilities here:

1. We may soon not need banks to carry out monetary transactions or keep our money. The benefit in terms of near-zero transaction costs, nearly immediate confirmation of payment (are you still waiting 4 days

for your cheque?), reduced credit risk, security and resilience would be immense.

2. Credit creation becomes an activity not linked to the transaction-handling franchise. It is also no longer underwritten by taxpayers. Inflationary behaviour requires public consent – not the taxpayer or voter public but the public that uses the particular currency.
3. Because all transactions are peer-to-peer, people can switch their currency holdings at will and costlessly. How much people trade, if at all, depends only their beliefs about the riskiness of the currencies on offer.
4. If peer-to-peer currency becomes mainstream, governments will have to decide whether to accept it and put the banks out of business, or refuse it and drive it underground. Either way, the relation of state and citizen in economic management is likely to be radically changed.

[Subsequently, serious allegations have been raised about the reliability and stability of Bitcoin. The question of whether or not Bitcoin is a good system is beyond the scope of this post.]

Venture capitalist Michael Eisenberg wrote in 2009:

> Why do we need banks at all? If it sounds crazy – a world without banks – it is not.
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> We have become so used to storing money in banks and talking to our banks that we have forgotten what they do. Simply put, banks borrow money from you, and lend it out to borrowers at a higher rate than they pay you in interest. That is it: Banks are lenders. They provide credit. Everything else is window dressing.***
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> You think banks provide safety? Wrong. That is the government and FDIC…. So why do you go to a bank? Because your brain has been trained to believe that you can trust them. [WB: Is that why banks have such big, solid architecture … to look solid and trustworthy?] Their brand means safety to you. You assume that their risk management is better than yours, and therefore will protect your money and enhance its value.
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> What if that assumption is wrong? What if we cannot trust banks to protect and enhance our assets? We would be left with one function for banks: lending money or providing credit. If we could replace that credit function, or if we believed that our own risk management was better than the bank's, then we could do without banks (someone else will give you that free mousepad).
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> Technology and the internet is going to provide this.
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> Sound farfetched? It is not. In fact, the financial world has been evolving in this direction for a while. We just chose not to pay attention.
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> Today, you can open an E*Trade account and do all your

> brokerage online for less cost than going through a bank. You can transfer money using Paypal. You can trade currencies through endless online options from EasyForex and SaxoBank for experts to eToro for novices. Think you need advice on investments or consumption patterns and fees? Forget your banker and try Seeking Alpha or Mint.com (full disclosure: Benchmark companies).
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> Which brings us back to lending. There are numerous efforts around P2P lending from Zopa to Prosper (Benchmark company). There are other nascent efforts around commercial lending (which anyway the banks are not doing now). Essentially, startups can use the web to provide risk management tools and investment opportunities that disintermediate banks and thereby make credit available to borrowers.
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> One of the things that got banks in trouble with mortgages was that they were divorced from their borrowers. The FDIC has a long procedure around Know Your Customer regulations, but banks do not really know them or their customers' creditworthiness. They were buying sliced and diced mortgage paper at a distance (which is why some community banks are in better shape – they really knew their customers).
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> Think ahead, and you can imagine a world where there are local social community lending tools that enable person to person or company to company lending where you can really know the borrower. Banks use technology for risk management and asset allocation. Why can't we put those tools in consumers' or business' hands? Are banks really experts? Are they bigger experts than crowd-sourced wisdom on creditworthiness or risk management?
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> Here is the kicker: one of the other roles banks play is they intermediate between the government (Treasury) and consumers and businesses to keep liquidity flowing in a risk-managed way. In the age of the internet, why can't consumers buy currencies directly from governments/central bank or currency trading platforms (answer: they already can) and access that liquidity directly? Businesses could as well. It is just a technology question. As always in creative destruction, it will happen from the bottom. Clunky tools like P2P lending will grow up and become full-fledged lending platforms with appropriate risk management that might disintermediate obsolete banks entirely.
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> [T]he banks have simply become a filter that robs consumers of 90% of their money.

And Reuters argues that prepaid cards can replace checking accounts:

Here's a little bit of personal finance heresy: Maybe you don't need a checking account at all.

"For basic monthly financial needs, there's no difference between a checking account and a reloadable prepaid card," said Michael Flores, the author of a study released Tuesday by the Network Branded Prepaid Card Association (NBPCA). "We see it as a financial products lifecycle. People in their 20s mainly need a transaction account." Flores is president of Bretton Woods, Inc., the consulting company that performed the study. He said the average prepaid

> card holder is 27 years old.
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> Prepaid cards are reloadable cards similar to debit cards. They may be offered through banks or through independent companies. They are growing in popularity as many government benefits are being paid via prepaid card.
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> If we cut out the giant banks as financial middleman, we might have a much more efficient economy, pay less in interest, fees and penalties, and restore a functioning political system and the rule of law.

This view has now gained an unlikely ally: Andy Haldane – Executive Director for Financial Stability at the Bank of England.

The Independent reports:

> The days of the banking middlemen may be numbered as a technological revolution in business lending shakes the dominance of the UK's biggest banks, a senior director of the Bank of England has said.
>
> The rise of peer-to-peer lenders such as Zopa and Funding Circle – which directly match up firms in need of cash with investors – and so-called crowd-funding, where small amounts are raised from a large number of funders, will challenge the nation's major financial institutions, according to Andrew Haldane, the Bank's director of financial stability.
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> He told The Independent: "The mono-banking culture we have had since the 1990s is on its way out. Instead, we are seeing a much more diverse eco-system emerging with the growth of new non-bank groups offering peer-to peer lending and crowd-funding which are operating directly with a wider public." [We've repeatedly noted that increasing diversity leads to improved financial stability.]
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> Mr Haldane also held out hopes that the fledgling revolution could tackle the crisis in business lending. This helped trigger the Bank's "funding for lending" initiative in the summer to kick-start credit markets.
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> He said: "I see opportunity knocking for finance. Hopefully, the growth of peer-to-peer lenders and those involved in crowd-funding will help solve the problems we have with lending for small and medium enterprises … The banking middlemen may in time become surplus links in the chain."
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> Mr Haldane said the rise of such lenders could bring down the costs of financial intermediation, adding: "IT has changed every other industry like film, music and even football clubs so why not finance? With open access to borrower information – which is held centrally and virtually – there is no reason why end-savers and end-investors cannot connect directly.
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> "Necessity is often the mother of invention. Now that the big banks are retreating from lending after the crash, these new methods of financing could help fill that gap."

While the American government is hostile to any challenge to the hegemony of the big banks, the Independent notes that the UK is *encouraging* peer-to-peer lending:

> The Government is also keen to encourage alternative finance and last week announced four peer-to-peer lenders will be given a total of £55m in taxpayers' money, an amount to be matched from private sources. The £110m fund is part of the £1.5bn Business Finance Partnership, part of the Government's drive to diversify sources of finance to business.
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> The sector will also have lending and borrowing activities overseen by the UK's new market regulator, the Financial Conduct Authority, from April 2014. The industry's trade body, the Peer-to-Peer Finance Association, said regulation will help to bring credibility and stability to the fast-growing industry as there have been concerns that a high-profile failure in an unregulated market would see consumers lose their money and jeopardise growth.

And France has granted Bitcoin permission to act as a real bank.

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