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Banking profitability varies directly with economic advance until the country arrives economically. Then its banking sector starts to falter, which is why bank ROAs are lush in Latin America but lower in the U.S.

A Life-Cycle View of Banking

ANDRE CAPPON

The evolution of banking and finance in various countries follows a common life-cycle pattern. As a first approximation, this life cycle is the result of fundamental economic and technological forces and, as such, transcends regulatory or institutional schemes. This life-cycle view of banking can provide valuable insights to managers or investors interested in anticipating change in the financial services industry.

In a nutshell, the life-cycle pattern we observe is the following: The role and profitability of a commercial banking system is a function of the degree of development of the economy in which it operates. As countries evolve from the underdeveloped stage to the "emerging economy" stage, banks become progressively more important and more profitable. A peak is reached when countries reach a level of development similar to that of the successful newly industrialized countries, such as Mexico and Taiwan. As economies progress further, however, the role o commercial banks erodes owing to the spread of information and the growing sophistication of financial market participants, which gives rise to more specialized, more focused, and "technologically superior" forms of financial intermediation. With this erosion in the scope of commercial banking comes, typically, a decline in the profitability of commercial banks and an increase in their assumption of risk. Ultimately, this leads to consolidation of the commercial banking industry in developed economies. (See Chart 1, which relates bank return on assets to gross domestic product per capita.)

The existence of this pattern is supported by two kinds of evidence: on the one hand, the historical "time series" analysis of commercial banks in developed countries, such as the U.S. or Japan, and on the other, comparative, "cross-sectional" analysis of banking systems in economies at various stages of development.

1. The historical decline of commercial banking in developed economies.

In the most developed countries, the traditional commercial banking business (i.e., taking deposits and making loans) has lost, or is quickly losing, its preeminent place in the economy, in

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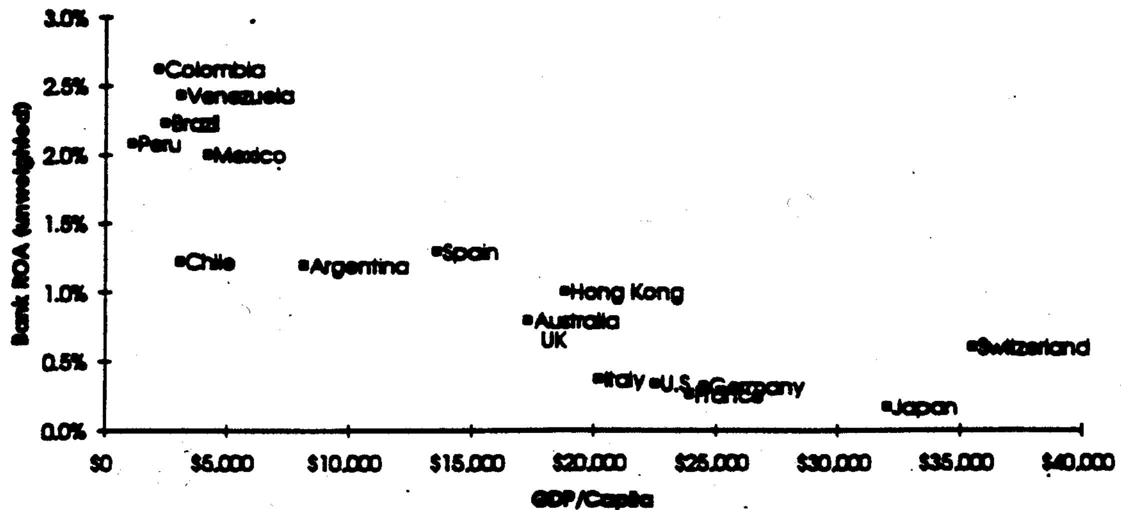
Chart 1: Bank Returns on Assets vs. GDP — 1991-92



Sources: *The Economist*, Salomon Brothers Inc., *The Banker*, CBM Group.

favor of more specialized nonbank competitors..

The trends are well known (although we will illustrate them with U.S. statistics, the same facts are generally true in most developed economies):

• A long-term decline in "cheap funds," such as demand deposits and float. In 1950, almost 70% of U.S. banks' liabilities were in demand deposits. By 1992, demand deposits had eroded to some 11%, as bank customers learned to use cash management and high-velocity payments technologies. As a result, the banks' once substantial cost-of-funds advantage over nonbank lenders has eroded.

• A long-term decline in the asset quality of commercial banks. In 1950, almost 70% of U.S. banks' assets were invested in highly liquid government securities and interbank money markets, while only some 22% were in corporate loans. By 1992, these proportion had reversed, with loans accounting for some 60% of assets, and liquid assets less than 20%. Furthermore, an increasing percentage of loans now goes to relatively low-rated companies, real estate borrowers, and consumers, as banks seek higher gross yields to maintain net interest margins in the face of an increasing cost of funds.

• The increasing scope and liquidity of securities markets, which have disintermediated the banking system, beginning first with low-risk, well-known companies and subsequently moving on to lower-grade borrowers and consumers.

• The growth of specialized nonbank lenders, such as finance companies and insurers. As of 1992, in the U.S., banks' share of total credit extended by financial institutions had fallen to only 28%.

• The growth of specialized nonbank investment alternatives: money market funds, stock and bond funds, pension funds. In the U.S., from 1972 to 1992, the share of bank deposits in household financial assets dropped from 25% to 15%. At the same time "managed assets," including pensions, insurance, stock and bond funds, and money market funds raised their share from 15% to 30%.

The decline in banking influence and profitability inevitably leads to industry consolidation, which is in part the result of the need for expense rationalization in the face of reduced demand. As the role of commercial banks recedes, other financial businesses advance and improve their returns. These include: capital markets businesses such as corporate finance, securities trading and sales, risk management and derivatives, investment management, and the variety of specialized services that support the investment process, such as custody. There is also rapid growth in businesses associated with the wealthier and older segments of the

population – i.e., insurance, pension funds, and trust or private banking.

2. The strength of commercial banks in emerging economies.

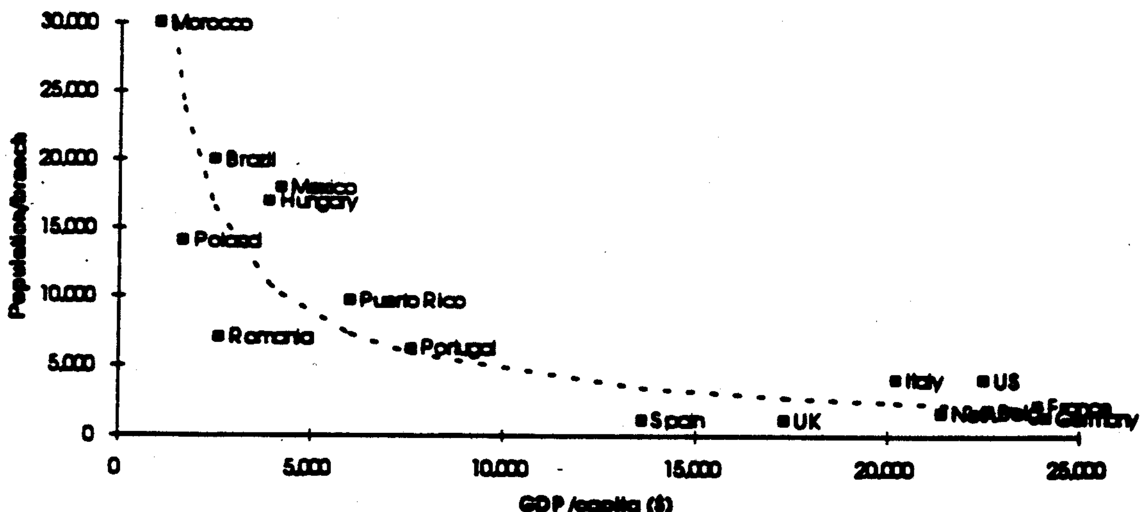
Traditional commercial banks, however, still play a central role in the financial systems of emerging economies, such as Mexico and Chile in Latin America and Taiwan, Korea, Thailand, and Malaysia in the Asian zone. In such countries, commercial banks are still able to generate float and cheap deposits and dominate the granting of credit to private corporations and public entities. Banks also serve as the primary vehicle for savings and investment. They tend to enjoy stronger credit ratings than their customers, which is no longer true in the U.S., and are usually quite profitable, even after allowance for inflation and the higher volatility of these economies.

Furthermore, whenever the economies in which they operate improve, or inflation is brought under control, the value of these banks soars, as it did, for example, in Chile and Mexico. It is no accident that the Mexican banks were privatized at extremely high multiples in the range of 2.7 to 3.9 times book value.

Emerging economies seem to provide the ideal conditions for commercial banks to thrive.

- Margins are high, since the competition from specialist nonbank institutions is not yet present. In Mexico, for example, net interest margins – i.e., the spread between the rate banks earn on assets and their cost of funding these assets – is around 5% to 6%, compared with 3.5% to 4% in the U.S., 2.8% in Europe, and 1.3% in Japan.
- Banks in emerging economies have plenty of room to grow, as the "money economy" expands. The ratio of M4 (the broad monetary aggregate defined as the sum of currency, demand deposits, and liquid securities) to gross national product is around 40% to 45% in Mexico, versus 80% to 120% in developed economies.
- The local economies are relatively underserved in financial services, such as consumer finance, middle-market credit, and housing finance. One striking aspect of underservice is the much lower branch density in lesser-developed countries, relative to industrialized economies, as illustrated in Chart 2.
- Banks are a leveraged proxy for the overall economy in emerging countries and typically exhibit growth rates higher than the GNP growth. This reflects the rapid takeoff of the modern "money economy," which occurs when a modicum of political and economic stability has been achieved. The example of Mexico is instructive in this regard. When Mexican inflation was

Chart 2: Branch Density Varies Directly with GDP



Sources: *The Economist*, CBM Group.

brought under control after 1988, and economic growth resumed, bank asset growth far outpaced real growth. (See Charts 3 and 4.)

To sum up, emerging economies provide the conditions for a golden age of growth and profit for commercial banks.

The stock market confirms the relative valuation of commercial banking franchises. In the United States, commercial banks account for some 6% to 7% of the market capitalization of the economy. In emerging markets, as defined by the IFC data base, banks account for 17% of market capitalization.

It has been argued that bank stocks should do especially well in what is called the second wave of performance in the equity markets of emerging countries. The first wave is related to infrastructure development: telecoms, cement, utilities. The "bank wave" occurs as households and businesses in emerging economies begin to borrow to finance their economic growth and consumption.

In preemergence, or underdeveloped economies, banks also enjoy high margins and can be quite profitable. However, since the money economy is a small part of the total economy, the role of banks remains small.

3. Implications of the Life-Cycle Pattern.

The life-cycle pattern has broad implications for bank managers and investors. For a bank CEO in an underdeveloped or emerging economy, life-cycle theory provides valuable clues to the future development of the financial system. The life-cycle model provides a framework for predicting the direction and pace of change. We can thus anticipate and explain strong growth in consumer finance, housing finance, and credit to the middle market for Latin America and the Asian "tigers."

For banks in transitional countries, such as Spain, Portugal, Greece, and perhaps Italy, the life-cycle concept suggests that the nature of the business is about to change and that a decline in the value of commercial banking franchises is about to begin. In such countries, it makes eminent sense to build a presence in investment banking, asset management, derivatives, insurance, etc.

For the CEO of an international bank with a presence in a variety of countries, the life-cycle approach suggests a strategy for international deployment. It will be very difficult to compete in developed economies as a commercial bank, especially since foreign banks tend to have weaker franchises than local banks. In developed economies, it is probably most attractive to participate in investment banking, asset management, and insurance. In emerging economies, it makes sense to participate as a commercial bank, and it makes even more sense to lead in the life-cycle sense – i.e., innovate and build an investment banking presence or an asset management capability. It also may make sense to make a few bets on countries that have a reasonable prospect to get to the emerging economy stage in

Chart 3: As Mexican Inflation Subsided . . .

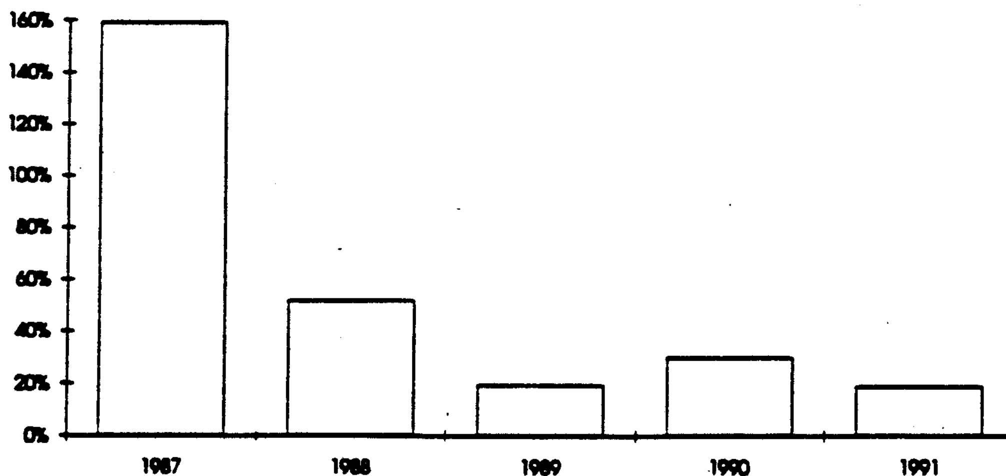
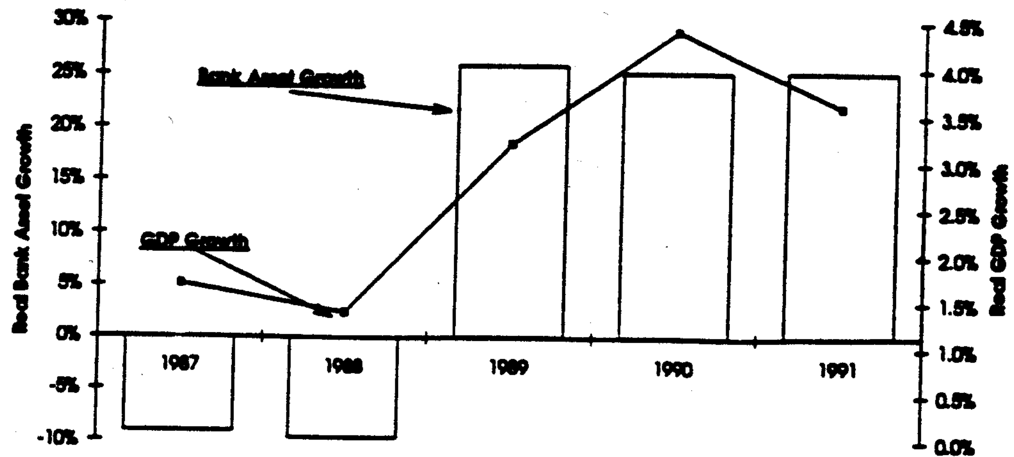


Chart 4: . . . Bank Asset Growth Took Off



the near future. Examples include such countries as India and Morocco.

For the investor in bank and financial stocks, the life-cycle concept suggests some portfolio guidelines: emphasize bank stocks from emerging economies, reduce exposure to commercial banks from developed economies, invest in asset management firms, etc. The life-cycle concept thus provides a basis for global sector investing in financial services stocks.

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