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# **Further Contemporary Issues in Financial Institutions and Markets**

**Barbara Casu, Daniela Fabbri and John O.S. Wilson**

On December 11<sup>th</sup> -12<sup>th</sup> 2012, the 3<sup>rd</sup> Conference for Emerging Scholars in Banking and Finance took place at Cass Business School, City University, London. The conference was jointly organised by the Centre for Banking Research at Cass Business School and The British Accounting and Finance Association's Financial Markets and Institutions Special Interest Group. The aim of the conference was to bring together emerging scholars working on contemporary issues in financial institutions and markets. The general theme of the conference was designed to allow for a wide range of submissions covering the diverse nature of academic enquiry in banking and finance. The conference also hosted a keynote speech entitled *The Role of Corporate Governance in Bank Failures during the Recent Financial Crisis*, delivered by Allen Berger (Moore School of Business, South Carolina).

Over xx papers were submitted to the conference; after a refereeing process, ten papers were selected for presentation. The remainder of this editorial provides a brief overview of the five papers ultimately selected for this special issue of the *European Journal of Finance*. The themes addressed cover a broad spectrum of contemporary issues in banking and financial markets, including: bank competition and financial stability; bank business models and interest margins; pricing and risk of credit cards; bank resolution; and foreign bias in equity portfolios.

Prior to the 1980s, the US banking industry was dominated by a large number of small, community-based banks, that adopted a Relationship Orientated business model (ROM) to offer differentiated or customized loan products and a highly personalized service at a relatively high unit cost. Subsequently, deregulation and technological change created new strategic opportunities for

growth that greatly extended the market reach of banks which survived the consolidation wave (DeYoung, 2010). Larger banks adjusted to a Transaction Orientated Model (TOM), defined as high-volume low-cost retail banking model reliant on scale economies, in which automated production and distribution processes deliver standardized products and services at low unit cost, while smaller banks continued to offer a customized service based on soft information. In the paper entitled *How bank business models drive interest margins: Evidence from U.S. bank-level data*, Saskia Van Ewijk and Ivo Arnold use a comprehensive dataset with bank-level data on over 16,000 FDIC-insured U.S. commercial banks for a period ranging from 1992 to 2010, to explore the effects of bank business models on interest margins. The authors find that as banks have shifted from ROM to TOM, this has fundamentally altered the structure of balance sheets and led to a reduction in interest rate margins as a by-product.

Over the past 20 years, advances in credit scoring technologies have allowed banks to price credit based on the riskiness of the consumer (rather than simply accept or reject an application based on a single credit score). The practice of issuing cards to higher-risk consumers was a significant change in the supply conditions of the credit card industry. The extent to which prices charged reflect the risk of the potential borrower is not yet clear in the salient literature. In the paper entitled *Credit Card Interest Rates and Risk: New evidence from US Survey Data*, Jose Linares Zegarra and John Wilson investigate whether the annual percentage rate of interest charged reflects the credit risk of potential credit card borrowers. The authors use survey data and an innovative matching procedure which links APRs charged by issuer banks with credit risk indicators of cardholders living where each bank offers its credit card plan. The results of the empirical investigation suggest that there is a negative relationship between long-term cardholder risk and APRs charged. This effect is particularly strong for sub-prime cardholders who benefit more from lower APRs compared to lower risk counterparts. The authors attribute these results to the fact that risky consumers shop around more intensively for credit cards offering the best terms and conditions. As such the results of this study complement and augment insights of prior literature

(Ausubel, 1991; Calem and Mester, 1995). Credit card characteristics also affect the interest rates charged by issuer banks.

The recent banking crisis in Europe has demonstrated the dangers of cross-border contagion. Early policy was mostly been through bailouts of banks by individual nation states. This was perhaps not surprising as no formal system is in place to allow the sharing of costs of recapitalizing large cross-border banks. As the crisis progressed and sovereign nations became heavily indebted, temporary funding programmes known as the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) were put in place. However, it was realized that there was a need for a permanent solution to provide financial assistance to EU member states experiencing financial difficulty. This led to the founding of the European Stability Mechanism (ESM) established in September 2012. In the paper entitled *the optimal size of the European Stability Mechanism: A cost-benefit analysis*, Daniel Kapp draws from the framework laid out in **Jeanne and Ranciere (2011)** to produce a core-periphery model to determine the optimal size of the European Stability mechanism (ESM). The author introduces a model, which develops regional best response functions, determining a set of feasible ranges for the total ESM size, given optimal regional contributions. He then calibrates this developed model to the European Economic and Monetary Union. The results of the analysis suggest that the optimal ESM size is more than twice the size of that agreed at the present time.

The extent to which competition enhances or reduces financial stability in banking is unclear. One view asserts that competition leads to excessive risk-taking on the assets (loans) side of bank's balance sheets and this leads to a higher likelihood of individual bank failure. More recently, studies have shown that competition may be beneficial to bank's portfolio risk. The traditional theoretical set-up assumes that the allocation of bank assets is determined by solving a portfolio problem emphasizing the liability side of the balance sheet. Upon confronting increased competition on the deposit side banks tend increase their offered rate to attract depositors. When paying higher deposit rates, neglecting the effects of competition in the loans market, bank earnings

decline. In order to cover lost profits, banks will tend to accept more risky investments. In contrast, when competition is restrained, banks exercise market power by paying lower deposits rate and therefore can increase their profits. As a result, banks in relatively uncompetitive markets are less willing to invest in low probability - high return projects. So, the probability of failure is less likely. Another strand of the theoretical literature assumes that banks solve an optimal contracting problem. Here the modelling framework attempts to measure the impact of competition on both sides of the bank balance sheet. In less competitive deposits markets, banks can earn greater rents (as noted above). However, banks can also charge higher rates in the lending market as well. The less competitive the market the higher the interest rates borrowers pay. Facing higher rates, borrowers tend to invest in more risky projects and therefore their probability of bankruptcy increases. This risk mechanism is further exacerbated by moral hazard on the bank borrower's side. Resultantly, banks become more risky in a less competitive market (**Boyd and De Nicolo, 2005**). **Martinez-Miera and Repullo (2009)** suggest a non-linear relationship between bank competition and stability. In the paper entitled *Bank Competition, Fire-sale and Financial Stability*, Ka Kei Chan and Alistair Milne apply a liquidity-risk framework to study how an externality from a forced (fire) sale of assets affects financial stability. The authors show that fire sales of assets create an incentive for banks to take excessive risk in order to obtain subsidies from other banks. The authors show that banks choose riskier funding structures as the number of banks increases in the economy. This suggests that competition leads to less financial stability.

Previous evidence suggests that the equity portfolios of investors tend to be biased in favour of home country stocks, and investors appear to be reluctant to diversify their portfolios geographically (**Lewis, 1999**). In the paper entitled *Cross-country differences in personality and the foreign bias in international equity portfolios*, Paweł Niszczoła argues that the sub-optimal allocation of funds abroad is the result of investors' attitudes towards other cultures, which is approximated by the openness to experience trait from the Five-Factor Model of personality. The authors utilise data on *openness to experience* in a culture from a previous large scale study of

individuals from 51 countries (**McCrae and Terracciano, 2005**). Cultures that score higher on the openness to experience factor are found to exhibit a smaller degree of foreign bias.

Overall, this special issue of selected papers from the 3<sup>rd</sup> Emerging Scholars in Banking and Finance Conference provides the reader with new insights and valuable contributions to the theoretical and empirical research on financial institutions and markets.

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