Comment

Why do we need banks?

Frances Coppola explains why, despite predictions that banks will cease to exist in a cryptocurrency world, they have become more indispensable than ever

Banks. Everyone loves to hate them. Ever since the financial crisis of 2008, when they nearly blew up the world, people have been trying to find a way of getting rid of them.

Peer-to-peer (P2P) lending would replace bank lending, we were told. Cryptocurrencies would replace bank payments. Money funds would replace deposits. Central banks, instead of relying on banks to create the money that people and businesses use every day, would simply create it themselves and government would spend it into the economy. Banks, who needs them any more?

Yet somehow, since the financial crisis, banks have managed to make themselves more indispensable than ever. The vibrant ecosystem of fintech companies and apps that promised to disintermediate banks has ended up relying on them. Banks are becoming essential infrastructure for the emerging digital financial system.

In the aftermath of the financial crisis, campaigns such as 'Move Your Money' encouraged people to abandon the big banks that had been so expensively bailed out, and move their funds to smaller, friendlier financial institutions such as building societies, credit unions and a new generation of challenger banks. The campaigners thought that if enough people could be persuaded to cut their ties with big banks, the banks would eventually disappear.

But these little financial institutions, both old and new, rely on big banks to hold their cash reserves and clear payments for them. So when people moved their money, they weren't disintermediating the big banks at all. They were embedding them in the new financial architecture.

The decline of physical cash and the growth of online and mobile payments have created an opportunity for banks. Electronic payments, both domestic and international, have long been intermediated primarily through banks: now, banks are establishing themselves as the gateways to payment services for the new generation of online and mobile payment apps.

You may think you aren't using a traditional bank, but there's always one lurking somewhere beneath whatever app you are using. Money transfer apps appear to disintermediate banks but actually rely on them. Zelle, widely used for P2P payments in the US, was created by a group of banks. Paypal uses the services of Bankcorp Bank. Wise, formerly TransferWise, partners with banks all over the world. Even cryptocurrency exchanges need banks to hold fiat currency balances and facilitate deposits and withdrawals.

Other banking services that appear to bypass banks similarly rely on them. Retailers that offer banking services are either licensed banks themselves (eg Tesco Bank) or offer those services in partnership with a bank (eg M&S Bank is a joint venture with HSBC) – and both of those supermarkets have discontinued their little-used current accounts. Credit cards may carry the brands of big airlines, oil companies or retailers, but they are always issued by a bank. Online marketplaces sell savings and loans ultimately provided by banks.

> *You may think you are not using a traditional bank, but there is always one lurking beneath any of your apps*

So banks are essential in our modern economy. But does it have to be like this? The history of banking is riddled with scams and panics. And often, the banks themselves survive but the people who rely on them lose everything. Could we design something better? Could we create a future in which banks as we know them disappear, replaced by decentralised marketplaces in which everyone interacts directly with each other?

De-Fi – the promise of decentralised finance

Led by bitcoin, cryptocurrencies grew, phoenix-like, from the ashes of the financial crisis. Sparked by the desire to end the dominance of both banks and central banks, bitcoin aimed to replace the bank-led financial system with a decentralised P2P system with its own algorithmically created currency. Inscribed on bitcoin's genesis block is this legend: "The Times 03/Jan/2009. Chancellor on brink of second bailout for banks". The message is clear. If the world adopted bitcoin, there would no longer be any need for banks and, therefore, no more of the hated bail-outs.

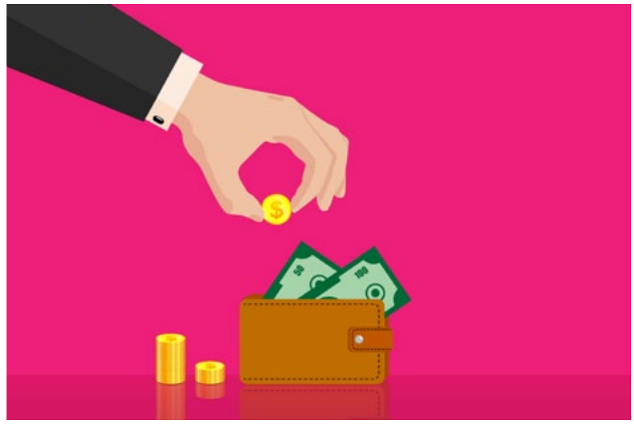
It was inevitable that, in the early years, cryptocurrency exchanges would have to use banks, because people can only buy into the crypto system by exchanging fiat currencies for cryptocurrency and, in the digital world, all fiat transactions involve banks, one way or another. But cryptocurrency's visionaries envisaged that as more people adopted bitcoin, fiat currencies would eventually fall into disuse, and the banks on which fiat currencies rely would fade and die. The reverse seems to be happening.

Far from eliminating central banks, the cryptocurrency world has created its own version of them, in the form of stablecoin issuers such as Tether and Circle. And now we are seeing attempts to develop cryptocurrency banks. They don't call themselves banks – they like to claim that what they are doing is something radically new and different. But Coinbase, for example, planned to accept cryptocurrency deposits on which it would pay a fixed rate of interest, and to make cryptocurrency loans on which it would charge higher interest and pocket the difference. That's the business model of a bank. It's also probably why the US Securities and Exchange Commission issued Coinbase with a 'Wells Notice', which is a threat to sue if it proceeded with its lending project.

The online P2P lending marketplace has similarly ended up creating what amounts to banks. Many of them rely on 'institutional investors', including banks, to buy the assets and some, such as Lending Club, have given up the pretence and become banks.

Why? The problem that banks exist to solve is the fact that depositors want to be able to withdraw their funds without waiting for the person who borrowed them to return them and they don't want to take losses if borrowers default. So, to attract customers, P2P platforms started to control lending risk, performing credit assessments themselves and turning down loan applications from poor credit risks. Some platforms permitted deposit withdrawals. Others borrowed their customers' money and lent it out themselves, rather than simply connecting lenders with potential borrowers.

As P2P platforms slowly transformed themselves into entities that looked very much like banks, they attracted regulatory attention. In the US, P2P lenders that borrow and lend must now register as securities broker-dealers, though as yet they are not required to obtain banking licences. In the UK, the Financial Conduct Authority (FCA) recently extended regulation of mortgages and home finance products to cover P2P lending. It also tightened governance and transparency regulations for P2P lenders. The FCA is also planning to beef up the rules on promoting 'high-risk investments' in 2021. But it too has stopped short of requiring P2P lenders to



obtain banking licences. This is presumably because they do not offer either 'sight deposits', or a guarantee that investors will get their money back. Those, such as Zopa, that offer savings products with a deposit guarantee have a bank licence.

The extensive attempts that have been made to disintermediate or eliminate banks over the past decade or so have all failed. Banking, it seems, is evergreen. Unless, of course, central banks step in. Many of them are considering introducing their own central bank digital currencies (CBDCs). In some models, these would be available to ordinary people and households. That could disintermediate banks, but it would also mean that banks no longer create money – which they currently do when issuing loans. That would place a burden on central banks to try to gauge how much money the economy can safely use and it would also make it difficult to transmit monetary policy via the Bank Rate.

But I'm not convinced that retail CBDCs would mean the end of banks. As long as people need a safe place to park money they don't have an immediate use for without locking it up long term, and other people need to borrow money, we will continue to need banks.

The crypto and P2P experiments have shown us that, with all its problems, banking is still the most efficient way of intermediating savings and lending. We need banks because, despite our best efforts, we have never been able to invent anything better. ■

Frances Coppola *is a writer and commentator on banking, finance and economics. She worked in banking for 17 years as a business analyst and project manager, running business and systems projects for (among others) RBS, NatWest, HSBC, Midland Bank and SBC Warburg (now UBS)*