Chapter 5

Conclusion and Recommendation

5.1 The Financial Crisis of 2007 and the Aftermath

The current crisis is not well understood in the media and also in the economic debate. It is similar to the Great Depression as its causes are discussed even until today. In public, the question about the reasons is answered quite quickly by the search for someone to blame: banker, bonuses, greed, corruption and speculation. Others see tragic human failure or contingent decisions such as the non-rescue of Lehman Brothers that brought an avalanche. All this is not wrong, but yet not completely correct and not pin-pointing the real cause or the origin of the crisis. It is obviously, a "systemic crisis" in which many factors interact. Greed in business is not new as it has existed previously. There is a question of how a small financial market segment of the subprime mortgage could become a crisis with enormous economic losses in the order of 10% or more of the gross world product, as well as how the owner of profit-orientated businesses allow such a high bonus payment. In the economic debate, other explanations focus on the financial sector mainly in the United States, or on the role of the supervisory authorities, in the deregulation trend and on the monetary policy of the Central Banks(Hellwig 2008), (Franke & Krahnen 2009), (Sinn 2009). Borio / Drehmann(Borio & Drehmann 2009) from the BIS point out that most financial crises in history have been created by excessive lending and asset price bubbles. Exactly, these risks were not detected early, emphasizing explanations about the lack of "macro-prudential" supervision (Brunnermeier et al. 2009).

The above mentioned popular explanation explains only little as there are analyzes that focus on the immediate or direct explanations(Shiller 2008), (Akerlof & Shiller 2009), (Crotty 2009) and(Brunnermeier et al. 2009). In the first place, there are four different forms of market failure that caused the crisis, i.e. (1) microeconomic market failures of banks and non-banks (2) market failure of certain financial instruments (3) market failure of financial markets in the form of speculative bubbles and (4) market failure in credit rating agencies. Alternative or complementary reference is made to three types of state failure i.e. (1) the banking and financial market supervision (2) the central banks in terms of their monetary policy and its involvement in banking supervision; and (3) ultimately responsible for the regulation of the supervision is the legislative or the appropriate government bodies.

Looking more precisely into the various explanations, then significant differences in the accentuations are quite clear. The key factor is the microeconomic market failure given the targeted exploitation and creation of information asymmetry, the increase in risk appetite, the exploitation of trust in government and central bank as guarantor of financial stability in the last instance. Some refer to toxic financial instruments in the sequence of financial innovations; others consider the tools not for the actual problem, but their excessive use. These various forms of market failure, in many ways classical reasons for banking crises, however, could only prevail because of government failure, driven by ideology and financial lobby.

Three different explanations will be briefly described here. Some claim that without the very expansionary monetary policy of the Fed and other central banks, the crisis would not have been possible. This view implies that the money supply ultimately can be controlled by the central bank, but certainly does not necessarily lead to price inflation of goods, but can generate asset price inflation. It also implies that it is the task of the central bank to fight asset price inflation. This of course raises significant theoretical and political problems. A second criticism of the central bank policy is rarely mentioned. Certainly not a few observers had warned of the risk that the housing bubble will burst; and therefore there is a need for restrictive monetary policy of the Central Bank. Bernanke was assumed to have consciously taken this risk and thought about the consequences to be as "harmless"as2001that it could be absorbed by aggressive interest rate cuts. This is the logic of inflation targeting and New Consensus, with the characteristic overestimation of the effectiveness of monetary policy. A moderate increase in interest rates and a more restrictive fiscal policy would undoubtedly have been the better policy mix. This ratherpost-Keynesi an view was not even in the thinking of those responsible, but hardly politically feasible.

A third view, which is today held by many critical banking experts and many other economists, however, emphasizes the lack of macro-prudential banking supervision(Brunnermeier et al. 2009). Systemic banking crises can arise even if each individual bank is rated as "intact". Basically, banks behavior-cyclically with regard to lending and risk assessment. Therefore, a new counter-cyclical supervision is necessary, which must be incorporated in Basel III, although not yet realized. Overall, the capital equity ratio of banks must be increased and also should vary counter-cyclically, depending on the assessment, when the leverage of banks is too high. This is implemented by deciding about the banking union and the supervision of the systemic banks in the European Union.

This implies finally that the traditional micro-prudential banking supervision was not the ultimate cause of the crisis and that for the Banking Supervision and the Central Bank, which originally have to do macro-prudential supervision, are in need of new tasks. Not deregulation but regulation is the problem.

This suggests the view, although rarely explicitly said, that the traditional banking supervision has irrevocably lost the race between financial innovationandregulation.Themacro-prudentialperspectiveemphasizes that financial system stability should be the top priority of the central bank policy, which has to be equipped with appropriate instruments. It must therefore identify and combat asset price bubbles. That would be in a sense a paradigm shift in central bank policy. There are difficulties with this proposal, which is being discussed in a slightly diluted form by the G20.

Without going into more detail on the different perspectives which focus on the financial sector, these are some observations of the author;

- It is a classic asset price and speculation crisis with a large and complex financial volume on the basis of financial innovation that had a rapid grow thin recent years.
- The various causes shown need to be seen in the system context, they all play a role.

Certain new financial products rein an outstanding position, less the subprime mortgages, but the particular multiple securitizations, CDO sand CD Sand shadow banks were organizational innovations. This has led to an over-complex house of cards, which was not accompanied by a particular international monitoring. In this respect, it is a crisis of globalization of financial markets.

- The predominant risk models were on the basis of the prevailing theories, techniques and models systematically inconsistent, both microeconomic and macroeconomic.

- The accelerators of a systemic financial crisis and its transmission channels into the real economy were, until the collapse of Lehman Brothers, misjudged.
- The traditional micro economic banking supervision was not up to the financial innovations. It was fragmented, and partially even based on the applicable laws which are in capable and in sufficiently coordinated internationally. Special Purpose Entities and various on-banks remained largely without control, although their actions significantly influenced banks. Systemic financial risks were hardly recognized, on the one hand due to lack of macro-prudential supervision of the central banks and the IMF, on the other hand, because no critical voices have been heard.

All the listed causes in the financial sectors cannot be explain detached from other major factors that indirectly set the prerequisite for the financial crisis and the subsequent global recession. They do not go far enough. These factors focus on the side of the supply of financial products, but neglect the explanation of the huge demand for high-risk financial products. The US financial sector has been flooded with demand for securities of various kinds by investors from all over the world, and not just since the beginning of this decade. The United States, partly Great Britain, became a magnet for risky assets, apart from other capital inflows. The decline of the consumption rate of households below zero was due to rising prices in assets, among others as a result of strong capital inflows from abroad. The growth patterns of the past years, driven by unsustainable private consumption, housing investment and high government deficit at moderate business investment, could not be possible without the capital inflows from the rest of the world. The fact that the US-Dollar, despite the existence of the Euro is the undisputed reserve currency of the world, reduced the risk of foreign currency investments in the United States. The monetary bonus contributed the constant willingness to excessive financial market risks. All these macroeconomic factors were a necessary condition to lead to the breakout of the crisis. The purefinancial market analysis hid these factors.

Many critical economists have pointed out in recent years that in the last two decades- not only in the US– there was tendency to a new financial capitalism, i.e. a “finance-led capitalism "or" financialisation”.(Hein et al. 2008)The terms describe the following trends:

- Money and credit are increasingly used for financial transactions instead of real transactions.
- Profit maximization is seen by increasing the share value of companies(shareholder value), by changing accounting rules ("market-to-market" or “fair value" rather than lowest value), while capital market-dominated corporate governance prevails, as well as value-oriented compensation of management, and elimination of barriers for mergers & acquisitions.
- Due to the above-average growth of the financial sector, driven by financial innovation, deregulation and globalization of financial markets, the financial sector is the most important growth industry, as if it were part of the real economy. Financial innovations are regarded as a kind of technical progress.
- Yield sand management salary in the financial sector grow and are increasingly becoming the standard forth real economy; the general income rate falls.
- The securities markets and other asset markets, e.g. real estate markets are prone to speculation and price bubbles.

These developments have been most strongly enforced in the US and in the UK, but radiate to the whole world, especially in emerging markets. The stock prices in the capital markets are to some extent regarded as pacemaker of the economy, not the physical capital accumulation and technological progress any more. Differences between the real economy and the financial economy are seemingly leveled. This gradual trans formation of traditional capitalism is the breeding ground on which the crisis-laden financial sector development took place, which finally led to the subprime crisis. Here also the explosion of executive salaries and bonuses in the banks have their original causes, as well as, the weak control of the management of banks and, more and more, of manufacturing companies, by their shareholders as well. All this goes far beyond the initially described root cause analysis of the financial market crisis.

It is the end of banks as we know them. After the enduring breakout of the financial crisis, the worldwide political authorities agreed that a change must be effectuated. The banks have to pay record fines, regulation increases the costs, low interest rates let the margins melt and digital competitors, beside many more factors, force the banks to rethink their strategies and their business models. The Banking Union is the showcase project of the European Union. The idea behind the law is to prevent banks in future to start accumulating bad loans again, jeopardizing the financial system and at the end making the government -thus the tax payer - rescue them.

It was decided about the Banking Union these days. On 4 November 2014 the European Central Bank overtook the task to supervise - at first - the 120-130 biggest banks within the Euro zone. On 6 November 2014 Germany passed a law which determines that the first addressees to rescue a bank are the shareholder and investors. European Union decided about the Banking Union and the member countries have to transform it into national law latest by 2016.

The supervisors can force institutions to underlay identified risks with additional equity capital, and they may require a particular provisioning policy or they can restrict certain business areas. In certain cases, fines can be imposed. When the supervisors conclude, there is a systemic bank that can't be rescued, the uniform settlement and restructuring mechanism (SRM) will be activated.

In summary, the Banking Union has 3 main pillars as mentioned above.

- Supervision and regulation,
- Single Resolution Mechanism (SRM),
- Deposit Guarantee.

It came out from the case of Lehman Brothers and the questionnaire that one main problem before the breakout of the crisis was a lack in regulation and supervision. Indeed, besides all critics, this step of the European Union in implementing the Banking Union is a tool to stabilize the financial sector.

The European Central Bank (ECB), in the last stress test in November 2014, did not check, if the business models of banks are profitable and sustainable in the long term - it would be at least as important.

The results of the stress tests were overall unsurprisingly: About 20% of the banks in the Euro Zone had difficulties with equity capital. Five of the approximately 130 banks tested needed to raise additional equity of around €4 billion. That should not be a problem for the financial markets. How hard it is for an individual bank to get the capital also depends on the respective business model. One problem, for example, is the term transformation. The banks borrow from their customers' money in the short term per day or fixed interest, which they then lend medium- or long-term at higher interest rates to homebuilders. This classic core business of banks comes under increasing pressure. Considering the increasingly lower interest rates, profit margins tend towards zero or are already negative.

To be independent from this, the banks would have to re-engage more strongly in the real economy. But this is not without any risks. Lending to companies and households is currently viewed in the public debate as positive, any resulting risks are macroeconomic, social and political and are actually desirable because they promote urgently needed investments. However, additional risks from new lending are something that many banks can barely afford in the euro zone. The regulation speaks against it. Even more, it is surprising that ECB Vice President Vitor Constancio expressed in the publication of the results of the stress test about its expectation that an increase in lending will no longer be refused by the banks, but depend on the demand of the borrower.

It is not expected that banks can meet such a demand in full. The ECB has already announced that it will now be a stress test every year. This will reduce the willingness of banks significantly to lend to companies whose creditworthiness is doubtful. Although these steps serve the stability of the system against crises, but a once lucrative source of income remains blocked to banks by regulatory restrictions.

At the same time, the regulatory costs for banks in the euro zone will increase further. Thus, soon a European bank levy must be paid and the deposit insurance fund has to be filled. In addition, an increase in refinancing by bail-in mechanisms is imminent, which are introduced in the context of the SRM.

Even if it is assumed that, despite the intense competition, part of these costs can be passed on to the customers, but the bank profits still get under enormous pressure. And this during a time that the banks have to accumulate reserves and find external investors to meet rising capital requirements. The regulatory and economic pressure on the banking sector in the euro zone will therefore continue to increase both from the income and the cost side.

Banks must react to this. Regardless of individual country-specific developments, generally two lines of development can be expected.

Economically stable banks will use of the opportunities offered and grow. However, they will only be able to very slowly, since they always have to keep in mind the regulatory environment. Moreover it is likely that banks which belong to the so-called national SIFIs (systemic important financial institution), can easier grow than those which do not belong to this group. Because a bank that is not a national SIFI yet, must hold additional equity capital, when exceeding the relevant hurdles, which, are generally dependent on the amount of the balance sheet total. Accordingly, there should be a clear distinction between these groups, because for a bank, it makes only little sense if it is only slightly above the corresponding key figures.

In this case, the relative cost of the additional required capital would be much higher than in banks, which have a significantly higher balance sheet total. The same is also true for the jump into the group of the global SIFIs. So there will be only for this reason a clear segmentation in the banking sector, which is likely to be directed mainly at the amount of the balance sheet total.

The rule would be thatbig banks grow while smaller banks will think twice to grow beyond the key legal figures, because then the relatively small bank has to make a relatively big jump.

Within this trend, the resource capital is very valuable for banks. Accordingly, it is also managed very carefully and the yield productivity of capital is expected to develop into a very important parameter, which also becomes a crucial decision variable for business decisions and commitments.

The other development path is expected to be the consolidation of the banking market. This can theoretically be done by market exits or through mergers & acquisition. The past has already shown that M&A in Europe were only very rare and appeared only in an “emergency”. Consequently, an increase of mergers of banks in the Euro Zone can be expected in the coming years.

This development is certainly to be welcomed in the light of market efficiency, because then the emerging banks should be better placed with regard to market penetration and cost efficiency. Not only weak banks may merge but even banks with a similar business model could find each other. It would be desirable in terms of a single banking market when cross-border mergers would arise. For the Euro Zone itself, this development would be very positive. A fragmented and low-profit banking sector is, for the development of an economic area, usually not very beneficial, especially since the competitive pressure from abroad continues to rise, which is primarily due to different regulatory requirements.

Lower profit margins and a complex business environment, which industrial/manufacturing companies have known for many years, are now experienced by the banks. It would therefore be surprising if the organization of financial institutions will not change fundamentally in the near future.

The hardest burden is the interest rate pressure on the industry. The profit margin in lending business has been shrinking for a long time and now hit the bottom. No borrower appears in the branches any more without not having already made the rounds to the competitors in order to find the best deal. No matter how good the consulting of these clients will be, fewer customers, are no longer willing to pay for good service for a few basis points more in interest rates. Even with a turnaround in the capital market, the pressure on the banks is not expected to diminish within the next two to three years. When interest rates rise, the institutions will have to increase the rates for savings deposits, so that clients do not withdraw the money, while at the same time, almost every debtor is in possession of a fixed mortgage. The Bank will therefore earn more only when the fixed interest rate runs out and can be renewed at better rates.

Burdensome is the impact of the new legislation which the banks are facing. So they have to follow, for example, stricter liquidity rules during the next few years. The institutes are only allowed to hold on a smaller scale of certain financial securities as a buffer. Instead, they are likely prescribed to park a higher proportion of their deposits at the National Bank, which means depressing the earnings due to negative capital interest rates.

5.2 Impact on investment banks

The so-called stand-alone investment banks haven deposits business, which is why their bank assets are relatively less liquid. Cash and cash equivalents are limited to a small fraction of high short-term liabilities. Thus, they are strongly dependent in its financing operations from the capital market, and the good will of other trading partners. Therefore, a bank-run can be triggered by external events or loss of confidence. This was the case in the aftermath of the crisis. The banks were finally forced to raise additional liquidity, either from other banks, from the central bank, or by selling assets.

The raising of capital in the market had dried up in the dramatic situation or at least became enormously difficult, and the assets decreased rapidly in value. Hence it was initially the bailout of Bear Stearns by the US government, along with the Fed. The declared aim of this measure was to protect the business partner to whom they owed money or with which they had agreed financial transactions. Shortly thereafter, the mortgage finance companies, Fannie Mae and Freddie Mac, and the insurance company AIG, were nationalized. For Lehman Brothers, however, they came to a different conclusion and let the158 years old institution go bankrupt. Then all the classic investment non-deposit banks came under enormous pressure. Bear Stearns itself was finallys old to JPMorgan and Merrill Lynch merged with Bank of America. Morgan Stanley entered intonegotiationswithWachoviaandLehmanBrotherswentpartiallytoBarclaysCapital(North America business) and partly to Nomura(European business). Goldman Sachs acquired billions of additional equity by the investor Warren Buffet. At the end, from the former traditional American stand-alone investment banks, only Morgan Stanley and Goldman Sachs remained independently, but gave up its status as a classic investment banks and thus fell as a traditional bank holding companies under the Banking Supervision of the Fed.

Since the business partner sandiness stors sat scattered around the world, the crisis quickly went global. Banks around the world had to massively depreciate investments. This led to huge capital support by the government. Discussions about "systemically important banks" resulted in the first compulsory expropriation since the Second World War in Germany in the form of the nationalization of Hypo Real Estate.

That was the end of what was once started by the so-called Glass Steagall Actas a consequence of the great stock market crash of 1929, i.e. the conscious separation of commercial and investment banks. Traditional banks took in deposits of customers and awarded long-term loans. They could fund themselves at the central bank, which in return controlled them. The less-regulated investment banks, which therefore could take higher risks, funded themselves on the capital market.

In recent years, investment banks have increasingly taken over the financing function of commercial banks by offering newly developed financial products, such as Collateralized Debt Obligations (CDOs). This was a profitable business, because investment banks, unlike commercial banks had to hold less equity capital reserves against potential losses. Finally, the massive losses on mortgage securities were too high for the tight fund in go investment banks. At the same time as the sources of capital in the credit markets from which they financed themselves dried up, the high debt could not be paid and the current concept of investment banks failed.

5.3 Changes needed by the Banks to avoid the future crisis.

The question of the "lessons learned" is provided to the banking sector in many studies and analyses. With the learning process, the banks have to change in behavior and in their business model.

The answers to these questions can be found in the analysis from the questionnaire and the case study such as the enduring political and economical discussions.

Banks need to focus more on business policy issues again. The relevant question of this thesis is what kind of business strategy would provide enduring success in this new environments.

The answer to this question is to find out which banks with which business model performed well even during the financial crisis. These comprise the decentralized, regional banks with their business anchored in the real business model. These banks have an adequate and diversified risk structure. Despite these successes, they feel the strong competition as well. For example, specialized banks, such as the so-called direct banks which now have a strong position in the market.

Their strategy is characterized primarily by;

- industrialization of the banking business,
- a concentrated product range,
- internet banking without branch business and
- intensive marketing.

Another question is whether there will be a business model in the future that turns to be the superior or will emerge different approaches side by side to lead to success in the market.

The future viability of banks depends largely on the extent on which they are able to establish a strategy that ensures;

- growth ,
- profitability and guaranteed return rate and at the same time,
- individual responds to customer needs and
- high quality of service.

Most of the banks tend to continue their usual business but start to realize that there are many changes occurring from customers, as well as legal and internal aspects.

5.4 New environments for new business model of banks

-*Pressure on the banking sector in the euro area*

Only in Germany the Banking Union causes annual costs of about 10 billion Euro. There are also other regulatory-related costs associated with Basel III and the planned financial transaction tax. This is accompanied by an average annual income of all German banks of only 9.5 billion Euros in the last 15 years.

-*Banks stuck in a structural change*

The banking sector is in a structural change, which his comparable to the change of the steel industry in the last century. Only when the institutions start to newly reinvent themselves now, they will survive in the long term. Since the outbreak of the financial crisis, banks are primarily concerned with "cleanup”. So the expansion of its digital strategy at many institutions lagged behind. Though, most financial institutions offer their customers online banking and also have an app that can retrieve the account balance via smartphone. But they do not do more. Theban slack the courage to innovate and the authorities just thought that their business model stands the time, which is dangerous. Young customers now a days feel much less connected to a bank. They invest their money where they get the best rates ,and this is often not their principal bank. Banks that do not respond to this trend will get big problems in the future. Therefore, banks should actually now invest in new technology. Many banks just do not have budget for it.

-*The financial institutions need to save money*

Most institutions currently have to save money. First, the interest rates are extremely low, then legal regulation forces the banks to accumulate equity capital and making the institutions earn on traditional banking business only slightly. Second, the customer behavior has changed. Many consumers are now found only rarely in the bank branches, so the stores become increasingly less profitable. For this reason, especially in rural areas, more and more branches will be closed. And this trend is likely to intensify in the future. The Fraunhofer Institute recently surveyed 400 banking executives and managers. 38percentsaid that their institution would have to close or merge branches before the end of the year(Neuhaus 2014).

But cutting cost will help only in the short term. Saving is not a business model. The institutions would have to be more responsive to the needs of consumers. Banks know very much about their customers but barely use this treasury of data. Thus, for example, the institutions could provide not only the appropriate loan for real estate. The aim must be to interlink banks more intensively with their customers. In this way, the banks could sell services in a package and earn money.

-*Consolidation of the banking market*

Without such innovations, the institutions will have difficulties. The banking business will become an entirely normal industry like almost all the others, with lower yield sand less risk. As a result of this development, there might be more mergers among banks in the coming years. This change will occur especially after the stress test which provided clarity on how the situation of the institutions is at the moment, and not just for the supervisors, but also for the competitors. Many banks could the re forefeel encouraged to submit a takeover bid to another institution. If there will be more acquisitions of this kind in the future, this could lead to various consequences: The big banks become bigger, while smaller financial institutions disappear from the market. We have to accept that some banks will not survive. "Too big to fail "therefore can be reformulated in to "too small to survive”.

-*Norilsk-free return anymore*

After the financial and sovereign debt crisis, the expansionary monetary policy of the European Central Bank(ECB) with the historically low interest rates is the next challenge for the financial industry. Furthermore, the ECB now collects penalty rate from banks which park their money safely wither. Meanwhile, the first private banks follow this example(Commerzbank in Germany, among others).

The banks all over the world face a tremendous change. This leads to the fact that all the institutions have to rethink their business model, as mentioned before. And indeed that's what's happening at the moment. This is not always voluntarily but forced by new regulations and economic change such as changing target group behavior.

Deutsche Bank is the leading institution on the German market. The bank claims that its business model became more sustainable and aligns itself with the customer needs and concentrates more on the original banking business. So, the executives dismissed thousands of investment bankers due to the reduced business volume in this segment. This is the trend in many different banks that can be observed, reducing risky business and go back to the traditional core business. This leads to intensified competition and to concentration on the market as mentioned above.

Another point to consider is that confidence in the banks is lost and it has to be restored. They paid themselves very high salaries and bonuses, are said to having gambled with the money of the customers and then had to be rescued by the money of the tax payers again. They seemed out of control and moral hazard needed to be restored. To gain back confidence of the customers, a bank has to change its business model to a more morally and responsible business. This also means that the exorbitant high salaries and bonuses have to be limited. There are political initiatives within the EU which try to handle these wrong set incentives.

The banking sector became uncoupled from the real economy and needs to remember their original tasks, which was to supply the economy with money. The goal by this original business was to support economic growth without causing sect oral bubbles that lead to crises.

The financial sector needs to remember that there is no unlimited growth. And especially, there is no unlimited growth only by making debts. The growth needs to be caused in a more "natural" way. This may prevent the banks from breaking down under a debt burden like happened to Lehman Brothers. On the other hand, it has to be ensured that in future, growth will only be allowed when there is enough equity capital and the maximum leverage ratio will not be exceeded.

This calls for control which should be provided by the legislation. The government takes over the tasks of the supervisor. This is carried out by the Banking Union, BASELIII and the rating agencies. One main task is the regulation and supervision of trade with innovative financial products. SIFI's have to be supervised very closely to identify risks before a potential crisis breaks out.

These criteria and the statements mentioned during the analysis of the questionnaire and the case study show that the structural change within the financial market is still not finished. The financial and especially the banking sector still have to overcome a lot of challenges which the author of this study experiences in his job in a national savings bank in Germany that has to implement several legal and societal changes and changes into its business model.

5.5 New focus of the banks in context of the bank business model

Classic models neglect technological trends. Thus, the title of the magazine Capital from September 2014 focuses on the end of the banks that we used to know them (Steins 2014).

In the past, many large banks have lost consumer trust. They promise to do better, talk about cultural changes and change their business models. The current market environment provides banks and financial institutions with major challenges. Who wants to keep its market share in the future or continue to expand, must actively respond.

Customers are increasingly inquiring critically about their banks. The market is saturated and lending loans is happening only very "restrictively". At the same time, new technologies and competitors put pressure on banks. More and more often also prominent industrial companies attract attention by founding or purchase a bank or institution with monetary services. Innovative business models and developing new markets are success factors of the future. Non-banks such as retailers, internet companies, telecommunications providers or platforms are entering the market and competing particularly in payments services and in savings and checking products with the banks (Steins 2014). This compromises retail business banks in their core business, while services in the Internet like PayPal are continuing to mature.

In the light of the current situation, the upcoming challenges and the existing business models, the first question that have to be answered is that in the light of the financial crisis, sovereign debt crisis and whether a superior business model for banks and what factors have to be considered.

5.6 Risk scenarios for the business model of banks

Three aspects overlap in their significance for all current trends and regulatory frameworks, i.e. the impact of low interest rates, the ongoing digitalization and confidence.

Period of low interest

On 4 September 2014 the European Central bank decided to drop the key interest rate for the Euro zone to the historical low rate of 0.05% from 0.15% (Spiegel Magazin 2014). It is not certain for how long this phase will last and what influence does the low interest rate will have on future business models in the bank business.

Ultimately, low interest rates are historically considered a successful instrument of managing financial and sovereign debt crises. It is therefore assumed that this phase will last for several more years. In addition, in the German fixed-rate culture, there is a reinforcing effect. Even if the period of low interest rates is coming to an end, the business model of savings and cooperative banks will still have a certain follow-up effect with correspondingly low results. In the US where there is a more adjustable interest rate culture, the effects occur immediately. Therefore, the fixed-rate exposures currently are protecting these institutions from an even faster drop in the income (Bauert 2014).

Digitalization

The second topic is the progressive digitalization, being pushed by four drivers with a high dynamic: The first driver is the technological development, as visible by a doubling of computing performance every 20 months. The second one is the growing Internet penetration within the total population. The third driver is the thematic development of the Internet usage. From a pure information search, we will see in a very short time the development of an intelligent Web 3.0. The user produces and consumes, as he is positioning opinions and consumes intelligent Web. The biggest driver for the growing digitalization is ultimately the continuous development of mobile devices. Today, the sale of smartphones is larger than the sale of mobile phones (Frühauf 2014).

As mentioned in the introduction of this chapter, there was an article in the magazine "Capital" about the end of the banks that we know them (Steins 2014). The content of this article is about the changing business model to a more digitalized one. It is about small Fintech companies that start to gain more and more market share by attacking the big and well-established banks. Google, Facebook and other big companies started to apply for a banking license. With that, they are able to offer traditional banking service, like payment or deposit etc. There are Apps on the market which have an integrated consulting and payment function. These are developments that started quite a while ago, not least when the number of smartphones in use exploded.

Customer confidence

The banks noticed that the customers gain more and more self-confidence in themselves in dealing with banking issues, no least but especially since the last financial crisis. By risky businesses and wide spread, misspelling banks have led the investors and customers to be in a deep crisis of confidence in financial institutions. Because they realize that their business model no longer attract the consumers, banks try to redraw it. Banks rely on the trust of their customers and thus always work on appropriate innovations. There are two ways to regain the confidence of the customer (Steinmann 2013).

1. External supervision and

2. Intensify customer relationship management (CRM) and transparent business model.

The point about supervision as a part of the external regulatory system was already described above. Nevertheless, there should be and has to be an internal division to observe the performance of the different divisions. The internal audit has the function to check the business processes and must ensure that legal and internal requirements are complied. But still, it needs time to restore trust because it was obvious that these mechanisms, which existed before the crisis as well, failed (Baseler Bankenvereinigung 2009).

Beyond that, the CRM has to be intensified. The banks face more and more competition and the income is decreasing. Furthermore, the customer does not trust the banks anymore, not least due to lack of transparency. And financial service should be more ethical and focus more on social circumstances such as ethical principles. So the core demand should be the following:

- **Stop harmful and ethically unacceptable investments**

Banks must stop harmful and ethically dubious investments and lendings as soon as possible. This means specifically: get out of the arms finance, nuclear power, coal and all the businesses that harm humans and the environment. To respond to climate change, banks need to measure the greenhouse gas emissions associated with their financings (e.g. loan for a factory), define and publish serious CO_2 reduction targets for its entire portfolio. Based on transparent, comprehensive and mandatory environmental and social standards, they should make responsible and sustainable investments in the future.

- **Stop speculation in food**

About one billion people on earth are starving, as they can no longer pay the increased food prices. Food speculation is substantially responsible for extreme price volatility. The banks should waive food speculation.

- **Exclude dubious financial products**

Many of today traded financial products have no relation to the real economy. However, they are often refinanced in case of a failure to the detriment of the tax payer in the real economy market. Global financial transactions were 75 times higher than the world economic output last year (Schnaas 2013). Example: betting on stock market indices. This speculation does not create values, but merely generates notional assets and bubbles that probably burst at some points. Therefore, the trade of these products must be regulated.

- **Increase transparency**

Banks must be more transparent. Referring to the banking confidentiality, they deny categorically public access to any kind of information to problematic projects and to their own specific ecological and social directives. It cannot be expected that banks would neglect the bank secrecy but the implementation of sustainable rules needs more transparency.

- **Improve counseling**

A banking product must not be designed complicated, so that it is neither understood by the bank manager nor by the customer. In a study of the magazine *Finanztest*(Neitzsch 2012) in the context of credit counseling within German banks, the Deutsche Bank recently received the grade "poor". The maxim still is: selling instead of counseling. The reason: The bank should change their bonus system so that quality counseling will be rewarded instead of pure sale.

- **Limit bonus excesses**

The bonuses and salaries of the executive and supervisory boards of banks are exorbitantly high and have dramatically disconnected from the general income development (F. A. Z. 2011). The salaries and bonuses are currently out of proportion to the performance provided. Furthermore, in the future, the Manager bonuses should be linked to the achievement of predetermined targets. The politics already reacted in that case and limited the bonuses for bank managers. It should not exceed the salary, except the shareholders allow it.

5.7 Conclusion: The ideal bank business model after the international financial crisis 2007

Now, almost all areas of banking operations are under pressure. The market is dispersed and the intensity of competition is high. The bank growth is close to zero and will probably stay there for a while due to the lack of population and economic growth in the western world. Fees and commissions in payments and securities are decreasing. In the latter case, the fact follows that the customers only demand simple products which will give small margins for banks not enough for their losses after the financial crisis. The interest rates, low overall, with little difference between short and long-term rates, do the rest, i.e.to use cheap funds and quickly lend it expensive and in a long term. The so-called deposit business works less and less. In addition, the increasing regulation drives up costs. Banks do not earn their cost of equity. The financial institutions are in descent, in a slow, but clearly recognizable process of decline and need finally to move.

Overall, an international supervision authority should be formed to monitor the global financial sector. The goal is to prevent another crisis that the world faced since 2007. The leading role should belong to the World Bank or more likely the Bank for International Settlements (BIS). Therefore this institution needs a legitimization from all the countries in the global financial union. Banks of countries without membership should only have restricted access to the global financial places.

There will be a hierarchical system. At the top is the World Bank or the BIS. The central banks of the state union areas like the European Central Bank have to render an account on the situation in their particular areas. Under the ECB, there are the central banks of the members of the union who render an account on the risks of their banks.

As a first step, it can be seen in the banking union in the European Union. With this law, the ECB becomes more or less responsible for the biggest banks in Europe. It has to supervise them, identify risks and eliminate them.

BASEL III brings many changes. These changes cost the banks a lot of money that reduce the profits. Higher costs and shrinking profits, during the prolonged low interest rate period put pressure on the banks but shall stabilize the financial sector. Especially, the lack of equity capital has become a serious problem to most banks. The assets lost in value and these losses had to be absorbed by the equity capital that was inadequate. That is why the governments had to rescue many financial institutions.

The international banking field will be following a trend to more digitalization and to a separated banking system. There are the universal banks and specialized financial institutions. The specialized financial institutions focus on a specific segment and they do best in home loan banking, mortgage banking, investment banking, auto banking and others.

On the other side, the new development should be the separation of commercial and investment banking. Nowadays, the banks do both investment and commercial banking in one company which means that the losses at the investment division become the losses of the commercial bank as well. In future, these divisions should make their business in their own separate company, which means that a failure of one division will not be the failure of the other, and the liquidation can be made independently from each other. A failure of the investment banking division will not therefore affect the deposits of the customers of the commercial bank. In addition, beside the fact that a bank should not be allowed to have a balance sheet total of over an acceptable level to prevent systemic consequences.

Another consideration is to break up the oligopoly position of the Rating Agencies. Their decision could make the whole countries slide from one into another deeper crisis. It might be wrong to establish a polipoly situation in the rating agency market, but at least there should be a balanced power of the institutions. So, the idea is to establish one in Asia, as the Chinese rating agency Dagong starts already to gain influence, and another one in Europe. After all, the work of these agencies must be more transparent, but not transparent in the case of their criteria, (otherwise the evaluated institutions would try to make sure that only these criteria are met). The international supervision authority should also be responsible to check if the rating process was correct or not. And then the authorities must be able to fine them for damages due to incorrect evaluation. Figure 5.1 shows how the financial banking sector will be organized in the future.

The current low interest rate environment and the rising costs of regulation have put banks under increased pressure to generate returns. To alleviate this pressure, cost-cutting measures, outsourcing and business model adjustments become long-term tasks. In addition, new competitors enter the market, which is expected to accelerate the transformation process in the industry. However, the remodeling of the business models will take some time. Until then, the pressure on profitability is likely to continue.

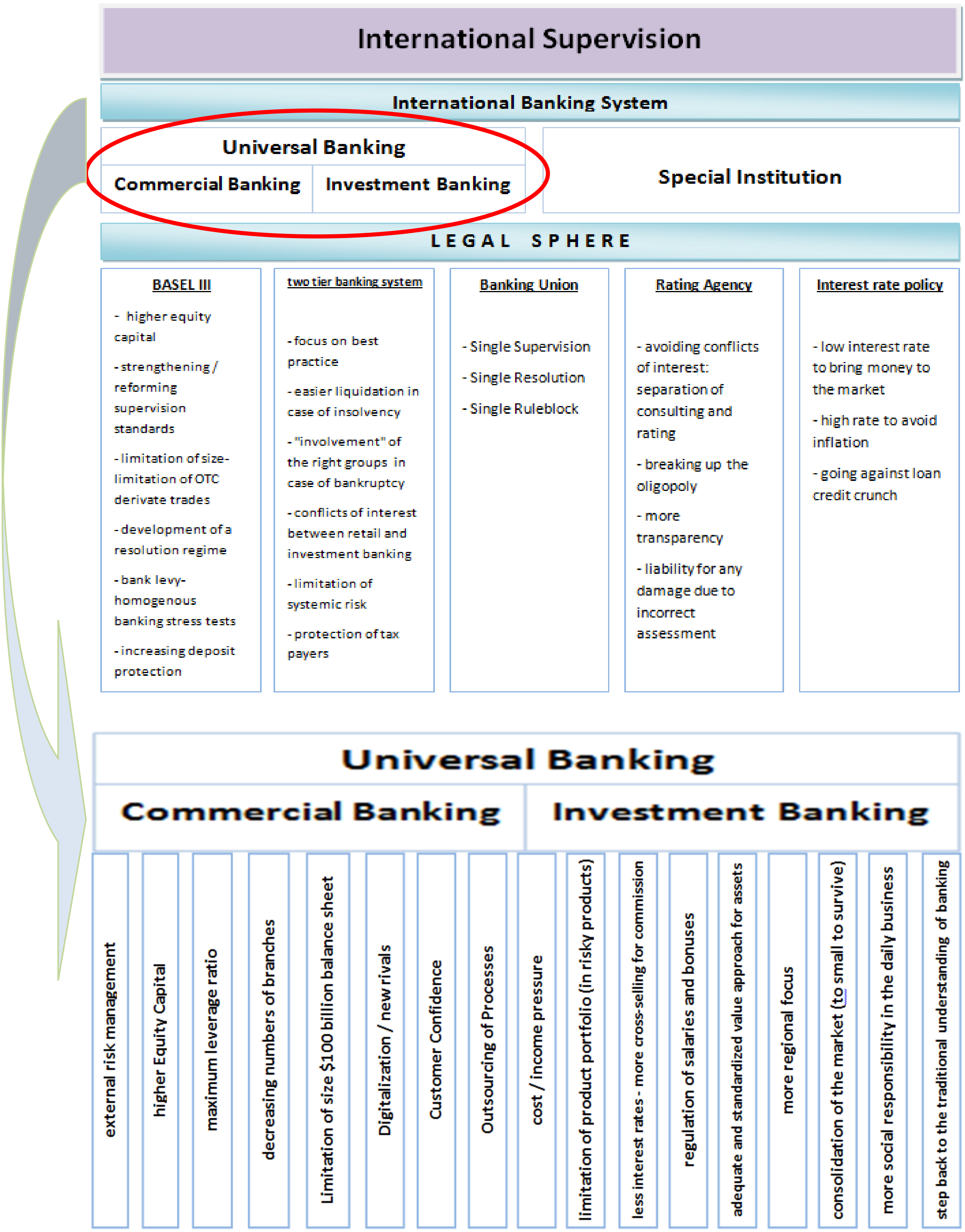

Figure 5.1 The new bank business model

The ideal sustainable bank business model is not a revolutionary one, but more evolutionary. Banks need to specialize and standardize their processes.

Many theorems made in the past are still valid. But some came out to be illusion. One was the belief in the beneficial effect of unlimited securitization of loans. Equally wrong was the assumption that risks can be measured and mastered with models. The most important question is whether we need to correct the belief in the progressive globalization of the financial markets. Banks have believed in internationally networks, and highly liquid financial markets, that provide the required funds efficiently. As the system collapsed in 2007/8, the globalization of financial flows are reversed since then, as the taxpayers and regulators are not global. They pay more attention to their autonomy and do not allow unlimited flows any longer. This puts parts of the concepts of banks into question. They cannot sell the same product all over the world, but it must adapt in each country to meet the local laws and regulations. There will still be global banks in the banking sector, but they will become more specialized. Very large banks with large deposits of citizens must always be closely controlled by public authorities and hold therefore more or less an implicit government guarantee. Even though a tier banking system is difficult to achieve, each division of a bank should be organized in such a way that at least large parts can go into bankruptcy without severe impacts on the others.

Three business models can thus be identified, i.e. (1) commercial banking refinanced through customer deposits, (2) commercial banking refinanced on the interbank or (3) capital market and capital market-oriented banks.

The first two models differ mainly in the refinancing of banks, while the third model stands out through the stronger involvement of banks in capital market transactions. On average, commercial banks specializing in the deposits have the lowest income fluctuations, and the commercial banks that are refinanced on the interbank or capital market are the most efficient. The banks that are specialized in capital market businesses are struggling to achieve a consistently better performance than the two commercial bank groups. The profile of a bank can change over time in response to changing economic conditions and to new rules and regulations. Around the recent financial crisis, the trend of business model changes varied. While before the outbreak of the crisis, an increasing number of banks refinanced at the interbank or capital market, but after the crisis, several banks return increasingly to more traditional commercial bank practice.

The business model of the future is in the main parts the business model of the past. It is referred to as a commercial bank specializing in the deposits business, i.e. the traditional business model. Their defining characteristics are that, a high proportion of loans in the balance sheet has a strong dependence on stable funding sources including deposits. In fact, customer deposits make about two-thirds of the total liabilities of the average bank in this group.

Banks based in the emerging economies were largely unaffected by the crisis of 2007-09. These banks have almost all deposits financed business models. But comparing with the banks in advanced economies, which have a similar business model, they achieved more stable results. Although favorable macroeconomic environments have undoubtedly contributed to their better earnings in recent years, yet their stable overall success is a greater cost efficiency basis, i.e. a deeper cost-income ratio.

While banks are still fighting against the regulators and for the trust of their customers, new player from areas such as mobile payments or crowd funding want to snatch away the market share.

Loss of confidence among established banks would mean that, well-known global financial companies are considered not per se to be more stable than new entrants. The banking industry is broken in by new players, who benefit from the loss of confidence of the banks. Also conceivable, for example, are salary accounts at PayPal, the purchase of investment products through online retailers such as Amazon or iPhone, as a mobile bank counter.

Unlike other industries, however the digitalization of the banking industry has so far been affected only marginally. Unlike the music industry the digital platforms, such as YouTube, had reduced sales down by over 40 percent. The increasing digitalization will now also hit the banking industry, and not without any consequences. Some people are already asking if banks are still needed. This could possibly go too far. But: In the next ten years, there will be massive changes, with the branch dying and a dramatic decline in revenues in private customer business. The restructuring phase will remain an ongoing task of the bank managers.

A real threat to banks does not exist, only alternatives. Furthermore, no one should forget that services such as that of Smava are dependent on cooperation with banks, since Smava or Auxmoney has no banking license.

But no matter how digital the financial institutions become, one movement cannot get stopped any longer. In the past, banks possessed a wealth of customer data, knew about the living conditions and were able to play the information off against the customer. The customer in return had only few possibilities to catch up independently on his bank. Today, however, he will find a wealth of information on his bank on the Internet. Many banks of the new generation, such as the direct bank Mone You or Quirin Bank, thus rightly see that online review sites such as Trip Advisor or Holiday Check in the hotel sector, will gain even more importance in the banking industry. Therefore, bank managers engage currently under high pressure in search for engine optimization. Only those who will be found on Google at first and get the best customer reviews, is likely to sell the most products in the future.

The banks cannot make up leeway what they missed in the past on their own. As mentioned, they have to take over online payment service companies to close the technological gap. These days, one can read in the news that, one of the big high technology firms like Apple, Samsung, Twitter or others, buy or invent a payment service. Many financial transactions nowadays are happening online. If banks want to stand the time and survive, they need to follow the trend to more online banking services. Banks still have the chance to participate in this change, because many companies do not have a banking license. So, there is potential for takeover, fusions or other forms of cooperation.

Though, the bank of the future is, by the previous explanation, an institution that comes back to its roots of the traditional banking, but highly digitalized and adapted to the high public regulation.

To compensate for the downsizing of the bank and the competition of the non-banks which all result in reduced income, banks should consider set up Private Banking as separate subsidiary to offer investment services to high net-worth customers, to meet the need of a growing number of rich people worldwide.

1.) The external and internal changes in the banking sector due to the crisis

There are many changes that come up in the banking sector as a result of the financial crisis. External changes are especially legal influences. The governments come up with stricter laws and bundle the supervision into a supranational institution to manage the worldwide interdependent financial sector. Then the ongoing digitalization has a significant impact on the business model of banks. New highly digitalized competitors enter the markets. The barriers become lower and more and more innovative, solutions are being brought to the market by high-tech companies like Google, Samsung or Apple.

Internal changes arise from the fact that, the business model they had before, is not up to date anymore and need to be overworked. These changes become necessary due to the external changes. Banks only react to impacts from outside. They have stopped being innovative long time ago, which cost profitability and returns. There is no way to escape from the digitalization process. They have waited too long and suddenly there come competitors (from other industries as well) that offer customers a different way of payment, like PayPal, Google Wallet or others. Banks should have participated long ago in this development. Now banks need to take great efforts to get back their innovation.

2.) The identified success factors to be implemented into an ideal sustainable international bank business model

In conclusion, there can be derived several success factors for an ideal sustainable international bank business model, i.e. to

- concentrate number of branches in a few strategic well located financial centers,
- follow the new digital trends or set new trends,
- focus on core competencies which is to go back to traditional banking,
- implement a regional focus instead of worldwide,
- intensify the risk management tasks and raise the responsibility,
- cut costs because more income can hardly be realized,
- link salary and bonuses to success linked to real banking business,
- increase service level to restore customer confidence
- independently acting divisions (to go back to Glass-Steagall Act),
- limit product portfolio(i.e. to ban high-risk products),
- link banking business to real economy again and curb speculation,
- set maximum leverage ratio / minimum equity capital,
- overwork accounting standards,
- set the maximum size of balance sheet (to avoid systemic risk),
- make the bank business models less complex and less nontransparent,

- less complex products,
- size limitation,
- clear focus on core competencies.

Due to these identified factors, it is possible to set a bank business model that meets the Present day requirements.

A good idea is to offer a checklist for an adequate bank business model which contains requirements for a more sustainable business model (e. g. minimum requirements for the formulation of a bank business model). By this step, a more harmonized and standardized banking sector can be achieved which at least reduces the complexity. This makes the institutions more transparent and easier to monitor and supervise, and finally limits the risk that could arise from an uncontrollable bank.

For a new bank business model, banks need to concentrate number of branches to a few strategic well located financial centers and implement a regional focus instead of worldwide. Then the trend that a institution has to offer all products that occur on the market has to be stopped. The product portfolio shall be limited and at least high risk products need to be kept in the proper proportion. That also means that the offered business should be linked mainly to the real economy again and speculation should be contained. Banks have to focus on their core competencies which mean to concentrate on the traditional banking and separate investment and deposit banking and create independently acting divisions. Establishment of Private Banking Units to offer high net-worth customers banking and investment services may help offset business taken away by non-banks. In addition, refinancing from the money market in extending loans must be contained to avoid risks and instability. Risk management of banks has to be intensified and the responsibility of the management for failure needs to be raised. Bonuses and the salary can be linked to the success whereat a focus should be less on short term profit but more on sustainable success. The accounting standards have to be overworked. There has to be a maximum leverage ratio and minimum equity capital and the size of banks has to be limited to avoid systemic risk. Over all, the business model has to become less complex and less nontransparent.

3.) Outlook

Observing all the changes coming up within the financial scetor, there are different opintions about where the development will end. While some say, this is the end of the banks that we know them other think it would not take long and all will be the same again. The present crisis will not be the last one.

At the moment, the banking sector faces a situation with historical low interest rates. There is a lihelilaod that the rate will rise again soon. Temporarily, the real estate sector in Germany are exploding due to high demand and lack of alternatives, similar to the beginning of the last subprime crisis in the USA.

The German Central Banks have reduced the interest rates and supply liquidity to the economy. The goal is to keep the economy going and prevent a recession. The same idea Ben Bernanke the chief of the Federal Reserve had before the last crisis.

The question is whether the famous economic theries of growth and efficiency have become obsolete after the current crisis. Critics preach the end of the growth. The growth rates of the last centuries were achieved by globalization because the internal growth had come to an end. It is famous by critics to question the theory of growth and the possibility of economic growth.

Indeed, unlimited growth by production is not possible without innovation. The world celebrates every percent of growth and is scared about a recession. Growth seems to be the only way to get out of the crisis. An Oldenburg economist, Prof. Nico Paech, sees things differently. He says that economic growth is not the solution to the problem, but the problem itself. Only a contraction of the economy prevents the disaster. In an interview with n-tv he said: “We cannot hold out the growth rate anymore, because different crises come upon us. They will end the party. Not only about ecological limits and historically unique resource shortages, but financial crises are the pacemaker of economic development beyond further growth hopes. We only gain back control in the monetary sector of a too large growing economy, if we are willing to reductions. For stabilization of the current state, there are simply no politically realistic solutions.” (Paech 2012) It is known that the job of the banks is to finance conniption, which means that as long as there is a demand for consumption, the banks will be a main actor for economic growth. Growth implies different aspects of a society. There are technological, environmental, political and legal spheres which need to be brought to the least common denominator. If this economic cycle keeps rotating, there will be further growth and even future crisis cannot be excluded. Following the theory of Prof.Paech would mean to stop growth and renounce consume and demand. This would at the same time mean that there is no technological innovations which is probably not desirable. Indeed, by growth reduction, crises could be prevented, but there would at the same time be a loss in wealth. But growth in the banking sector should not happen independently of the real economy. This is an aspect that will change in future. When this goal is achieved, crises will not disappear, but there will be no more crises caused by the financial sector.
