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Banks or fintech companies — who will dominate the credit supply chain?

BY ET CONTRIBUTORS | UPDATED: AUG 16, 2018, 06.19 AM IST

Post a Comment

by Deep Narayan Mukherjee

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Technology tends to remove intermediaries from supply chain and thus increase efficiency. Bill Gates in 1994 commented that banking is necessary, banks are not. Since then, technology has helped banks to innovate and grow. However, with the advent of fintechs globally, Gates' comment gained relevance. Part of the uncertainty associated with the future of banks is attributable to the popular narrative that banks' are intermediaries. It may be argued that banks are much more important to an economy and government than the tag of a 'financial intermediary' may suggest.

Commonly two models are used to describe banking. As per "financial intermediary" model, banks take deposit from savers and lend it out to borrowers. The second being the "fractional reserve" model of banking. Here banks are treated as intermediaries, which requires an initial deposit to kickstart the credit creation cycle. Both these models suggests that deposit gives rise to credit .While simplicity and intuitive appeal make these models popular, they do not explain banking comprehensively.

Richard Werner's empirical work (A Lost Century in Economics: Three Theories of Banking and Conclusive Evidence) suggests that fractional reserve banking and financial intermediation theory are not borne out in terms of data evidence. Implication being that in a modern economy, the credit creation model, which is the third model and also the oldest, may be used to explain significant portion of the bank's functioning. This model suggests that credit creates deposit and not the other way round.

Operationally, when banks disburse credit they simultaneously open a liability/deposit account in the name of the borrower. So, where nothing existed, an asset (loan) gets created along with a liability (deposit) in the banking system. The deposit adds to the money supply as it adds purchasing power to the economy. Banks are like agent of the government, which disburses credit and creates money in the economy, the money being backed by the government.

The credit creation model is a well-established model globally. Bank of England prominently featured the ‘money creation’ aspect of commercial banks. In June 2018, the Swiss held a referendum to restrict commercial banks from creating money when they lend in a bid to enhance macro financial stability. The third model may provide added justification to stricter regulations on commercial banks, which create money when they lend, vis-à-vis NBFCs that cannot create money. Credit, deposit and, by extension, money is an account of who owes how much to whom and at its core all three are information. As such, banking is possibly a mix of all three models. However, banks with their regulatory privilege (and for good reasons) are not just intermediaries, which can be made redundant by technology in foreseeable future.

Thus, often fintechs collaborate with banks in the credit-creation supply chain. The elements of credit supply chain may be broadly segregated as data, information, analytics and capital. In the current scheme, banks are the sole provider of capital (mostly equity) for credit creation. In the past, leading banks owned information and analytics components of this supply chain, allowing them to decide for whom to create credit and how much. Fintechs are taking rapid strides in the information and analytics component of the credit supply chain. Not all partners in a supply chain capture value equitably.

The value captured by each partner in the supply chain depend on the value they add and the relative scarcity of these components. To explain, if capital is scarce, then capital providers such as banks will capture significant value created in the supply chain. If providers of other components are not qualitatively improving the supply chain in which they participate, they will capture limited value. Their supply chain will lose out to other more efficient credit supply chains. Efficiency of credit supply chain is driven by ability to reduce credit cost, take faster credit decisions and disburse higher amount of credit.

To thrive, banks should evolve strategies which focusses on its credit creation power and not limit its thinking as ‘just a financial intermediary’. The banks may like to explicitly recognise, other than capital, which components of the supply chain they would maintain inhouse vis-à-vis partner with fintechs. Banks should deliberately choose the type of fintechs they partner with as opposed to running after every ‘shiny object’ any fintech may provide. Fintechs’ on their part need to choose supply chain lead by banks with efficient cost of capital and ability to orchestrate an efficient credit supply chain.

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