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Banking business models and the nature of financial crisis

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Highlights

- We analyze the heterogeneity between business models among systematically important banks since 2000.
- We estimate the risk-return profile of systemically important banks.
- Our analysis of banking business models relies on a portfolio theory.
- We document that the model with the lowest individual risk appeared to be the most systemic risky during the mortgage crisis.
- We find that the systemic risk is mostly related with the funding structure.
- The regulators should place greater emphasis on bank liability structure instead of relying solely on asset structure, while reforming the banking regulations.

Abstract

In our paper, we analyze heterogeneity among the various business models that incorporate systemically important banks in 65 countries over the period of 2000 to 2012. For the first time, we identify true banking strategies in a portfolio context, that is, consisting of various combinations of bank assets and funding sources. Next, we estimate the way distinct strategies have affected bank profitability and risk before the crisis, as well as their impact on the mortgage crisis. We demonstrate that during the mortgage crisis, the investment model indicated the lowest individual risk and highest systemic risk simultaneously. Consequently, we document that the funding structure was responsible for the systemic effect of the mortgage crisis. Further, we demonstrate that countries with systemically important banks that rely on investment activities experience a greater, but more short-lived decline in GDP, when compared to countries that have predominantly traditional banking activities.