Piercing the fog: the future structure of the finance industry!

The problem

There are reasons to believe that the finance industry is going through fundamental strategic shifts that will change many of the underlying premises and the ensuing processes. Events of 2008 and beyond have induced the nearest thing to a shock and several post shock tremors continue to emerge. The ultimate apparent outcome is a significantly different finance industry. An industry where e-finance, shadow finance, concentration finance and low equity finance will dominate.
These fundamental shifts and their potential applied impact will be the focus of the following article. It is a fresh insight into the changing dynamics of the finance industry and the outlook for this industry over the next decade.

Strategic industry shifts

Industry structure is that mix of flows, processes, players, products and strategies that exist, and relate, within a given business arena. It is a dynamic whole continuously adapting to benign as much as malignant influences. The finance industry provides a typical example for this dynamic ever changing whole. Events of 2008 and beyond have induced restructuring of operators, rationalization of players, elimination of products, downfall of leaders, re-regulation of frameworks and a generous dose of soul searching. It, more importantly perhaps, opened the door for industry strategic and structural shift.

The following analysis identifies four prime forces of structural shift within this finance industry: process shift, player shift, product shift and input shifts. Each is analyzed in terms of changing texture and consequent influence.

1.E-finance, a process shift.

There is an ongoing process of migration of credit and capital market operations from the familiar physical and human environment of the majority of banking and investment institutions to electronic platforms. An interactive process between the client and the respective databases of the investment or retail banking institution takes place and, through it, transactions are conducted. Those transactions could go all the way from security and asset acquisition to full portfolio management.

This innovation is leading to the emergence of three fundamental changes in the way retail and investment banking processes are conducted: digitalized banking monetized mobile communication and the social media investment vehicles.

Fully digitalized banks are banks entirely reliant on electronic communication to conduct retail and investment operations. Human interface is kept to a minimum and the customary physical and human environments of retail and investment-banking institutions may all but disappear. Digitalized banks will have a vast competitive edge over conventional operators in terms of both economics and reach. (Mckinsey July 2014, Economist, Nov 9, 2013). Atom Bank of Britain, a bank whose operations are due to start in 2015 with a full line of retail banking services provided on line and not through other alternative routes, is one of those. (Guardian April 9, 2014). Thirty-five percent of banks' market share in North America could exchange hands by 2020, as traditional branch banking gives way to digital banking and as new types of competition emerge (Accenture, 2013).

Monetized mobile communication equipment's involve highly automated gateway platforms substituting traditional interbank processes. Mobile apparatus are then used for the settlement of payments and the provision of a substitute for cash or credit cards demanded by the purchase transaction. This convergence and integration of e-commerce and mobile technology will radically change the shape of the payments market place (Banking Technology April 25, 2014).

A social media investment vehicle is a medium that blends a social media function with an investment banking operation. Tencent, a Chinese social media operator did exactly that when it entered into a strategic alliance with several Chinese securities firms in order to provide participants in their QQ chat with a one stop financial service channel. This service involves acquiring securities and wealth management products as well as managing the emerging portfolio (China Daily June 27,2014).

Those three technological innovations, or disruptive technologies, are changing the very process of retail and investment banking.

2.Shadow finance; a product shift.

Shadow finance or the system of credit intermediation that involves entities and activities fully or partially outside the regular banking system, plays, in the United States among several other key economies, an expanding role. This role exceeds, at times, the role played by regulated financial intermediaries operating within the realm of State control. The future could enhance this role.

There are, in the United States, two types of shadow finance. There is shadow finance produced by financial intermediaries isolated from the formal regulatory framework of the State and the customary access to central bank liquidity and public sector credit guarantees. There is also shadow capital created by regulated intermediates operating beyond their assigned prerogative and opting to become invisible to the regulator (Michael Simkovic 2009).

Unregulated credit generated by regulated investment institutions played a key role in the capital market havoc of 2008 and beyond. Those off-balance-sheet vehicles that were notionally separate from the banks but in practice dependent on them, were meant to expand credit, stimulate investment and reduce risk. Yet it all backfired when their very foundation, or underlying assets, turned out to be a risky amalgam of securitized mortgages and loans.

Shadow finance is sizable and continues to grow in the United States and several other key economies. US shadow banking industry stood at about $15 trillion in 2013, making it at least as big as, if not bigger than, the traditional banking system (Noeth B J, Sengupta R, 2011). Shadow banking supply within the 11 largest economies of the world and the Eurozone amounted to a near $60 trillion as of late 2011 (The Financial Times, 2011-10-27). Those countries delivered, in 2013, about 80% of global GDP and 90% of global financial system assets (FSB, 2013). Advanced economies possess, in terms of absolute size, the largest non-bank financial systems of the globe. So-called other financial intermediary assets represent on average about 24% of total global financial assets, about half of banking system assets and 117% of GDP. Those assets grew by 8.1% in 2012 with emerging markets showing the most rapid increase in non-bank financial system assets (FSB, 2013).

Emerging economics have their own version of shadow capital too. Search for an alternative to state owned capital entities in China, for example, has led to the rise of a Chinese version of shadow finance i.e. trusts, leasing companies, credit-guarantee setups, money-market funds and similar. Those are largely based on business networks and bilateral business interests more than a solid underlying asset (Economist, May 10, 2014).

Shadow banking and shadow finance are pivotal players within today's credit and capital markets. This is likely to continue and expand. Growth will be driven by a variety of factors including technology-based systems for bilateral and trilateral asset trading and investment transactions that do not require the help of a financial intermediary.

3.Concentrated finance; a player shift.

Capital market operations in the United States in the first place and some other key capital markets in the second, are conducted by a gradually declining number of operators leading to a progressive measure of high concentration in the industry.

Concentration is a measure of control of major markets and industries by a few players (Sherer, 1980). One of the two most commonly resorted to parameters is the concentration ratio or the relationship between the market share of the four market leaders and the total market. High concentration level is judgmental and the author is of the view that the ratio could vary per industry. According to the author, an investment industry concentration ratio of 50% and above could be considered high.

The following table features the level of concentration into the investment banking and securities dealing branch of the United States in 2007. Data is slightly out of date due to census time cycles. Yet, there are reasons to believe that the rationalization of investment banking institutions, that took place in the wake of the 2008 financial crisis and beyond, has increased the share of the largest investment banking institution well above what may be considered a prudent level of concentration for an industry of such an exceptional significance to the economy. JP Morgan Chase acquired investment bank Bear-Stearns in March 2008, Bank of America acquired investment bank Merrill Lynch in September 2008 and Wells Fargo acquired Wachovia in January

2009. The five largest U.S. banks had approximately 45% of the U.S. banking industry assets in 2008, a level that rose to 48% by 2010, and is very likely to be higher today.

Table (1) Concentration in the US investment banking industry

United States Industry classification 523110	Industry	Number of firms	Concentration ratio
	Investment banking and securities dealing	4 largest firms	51.7
		8 largest firms	76.6

Source American fact finder

The United States picture matches the picture in several other markets as China, which is probably the second most dominant global capital market player today. China's Industrial and Commercial Bank of China (ICBC), Bank of China and the Agricultural Bank of China are more likely than not to command a combined Chinese banking industry wide asset share of 50% or above.

4.Capital mix , an input shift

Corporate mix of capital inputs is changing. A projected lower contribution by equity is corresponding with a move towards debt and a geographical shift of financial assets and the management thereof, to emerging markets.

According to current projections, contribution of equity to investment capital is likely to decline in the course of the next decade. United States investor appetite for equity is , more likely than not, to decline over the next decade as a result of aging population; shifts to defined-contribution retirement plans; growth of alternative investments, regulatory changes for financial institutions; and response to low returns and high volatility of markets. (McKinsey, December 2011).

Growth of financial assets in developed economies is also slowing. Today, investors in developed economies hold nearly 80 percent of the world's financial assets, or $157 trillion, but those assets are growing at a slower rate than those in emerging markets. A growing "equity gap" or a gap between natural supply and corporate investment requirements, could, as a result, emerge. This gap which will amount, by 2020, to approximately $12.3 trillion in the 18 countries included in the research could lead to a rise in the cost of equity and a possible shift to debt to finance growth. Only a tripling of equity allocations by emerging market investors could head off this drop in demand for equities—which will be difficult to accomplish in this time-frame. The ultimate probable outcome is a world where balance between debt and equity shifts (McKinsey, December 2011).

All of that is taking place at a time when capital needs of the fast-growing emerging markets are making them a natural destination for global capital assets. This is further stimulated by measures being taken by some of those emerging markets to attract investment capital and assure investment interest. China's new rules for security trading and public offering that include enhanced trading and clearing technologies and reform measures of new equity issue system, are an example (China Securities Regulatory Commission, 2010). Those measures are likely to enhance IPO migration to the dynamic markets of Shanghai and Hong Kong and, with that, the very management process that goes with those IPO's.

The applied implications

The ultimate outcome of the interaction of all those forces is a significantly restructured industry. An industry where:

- Individual professional competencies carry a distinct IT slant.
- Software in the first place and hardware in the second, constitute a significant component within the overall industry communication and service infrastructure.
- A powerful underwriting industry emerges in emerging markets.
- Key capital markets in countries as China become pivots for equity supply, IPO operations and capital market reforms.
- Investment banking rivals compete within a high concentration mode in the United States but also several other global markets.
- US investment banking concentration turns into a global investment institution concentration with key emerging market players as ICBC Industry and Commerce Bank of China, assuming a key role.
- Equity contribution to corporate capital finance declines.
- Governments assumes some private capital market functions
- Sizable new structured finance products with less lethal content emerge as a supplementary source of capital.

Summary and conclusions

There are reasons to believe that the finance industry is going through fundamental shift that will change many of the underlying premises of the structure and the ensuing process. Events of 2008 and beyond have induced the nearest thing to a shock and several post shock tremors are emerging. Prime areas of change are process related, player related, product related and input related. The ultimate outcome is a significantly different finance industry. An industry with structural change in infrastructure and a shift towards e-instruments and software platforms. Also an industry with higher concentration, greater role of shadow markets and altered capital mix. The implications are wide ranging from a change in individual operator competency profile to a structural role for emerging market in issues as capital supply, IPO offering and capital market reforms, and, finally, greater government assumption of private capital market functions. Agility and innovation are becoming critical for banks and the finance industry as a whole today.

***For references, please refer to the on-line version of this article.*

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