

**SURVIVING  
IN THE  
FINANCIAL  
JUNGLE**

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# SURVIVING IN THE FINANCIAL JUNGLE

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# PART I

# INTRODUCTION

# ABOVE THE JUNGLE CANOPY

## CAN BANKS STILL SURVIVE IN THE FINANCIAL JUNGLE?

What the Amazon rainforest is to our planet, the banks are to the financial world. They are the lungs that supply the oxygen to keep the (financial) world turning. But just as with the Amazon rainforest, there are many threats lurking for the banks. New players are emerging who are challenging the banks by offering new products and services, meaning that the playing field – which the banks once had all to themselves – is suddenly getting crowded. The financial world seems to have turned into a jungle where anything goes. But the banks themselves are not entirely blameless either. For a long time, banks were known as quiet, stable institutions run by respectable leaders. From a young age, we were taught to put our money into a savings account, because that was safe. We would pop in to take out a loan for a house or a car. For investors, bank shares were seen as safe havens: there was little risk, you received a handsome share of the profits paid out as dividends every year, and the share price kept rising.

Until 2008. That was when Lehman Brothers went bankrupt.

Its collapse sent shockwaves through the financial world. Suddenly, it became clear just how heavily the banks depended on one another. That single collapse set off a chain reaction that spread across the globe. Banks worldwide ran into trouble, and governments were forced to bail them out using taxpayers' money.

Fortis, one of the figureheads of the Belgian financial sector, was teetering. Dexia, another major Belgian bank, had more skeletons in the cupboard than anyone could ever have imagined. And the third major player in the Belgian financial landscape, KBC, had to be bailed out too. Fear reigned supreme on the financial markets, not only in Belgium, but in other European countries as well.

Then the questions came: how was this possible? And who was to blame for this disaster? Banks and bankers came under intense scrutiny and were held accountable for their actions. The central question in that process was: what do we actually know about the accused?

Very little, as it turned out.

## WHAT WENT WRONG WITH THE BANKS?

Although everyone has a vague idea of what a bank is and what it does, very few people fully understand how banks work. The bank branches that we still find in almost every town are the bank's public face, but behind them lies a complex world. That makes banks somewhat mysterious, but when it became clear what was going on behind the scenes, that mystery lost all its charm.

Banks had invested heavily in products that they themselves did not understand or barely understood. The experts in whom everyone placed their trust turned out to be merely thinking of their own interests. Chief amongst the offenders were abbreviations such as CDO, CMO, ABS, MBS, and CDS, the precise meaning of which was clear only to insiders – and even then, one might question whether they were aware of all details and implications.

Belgian bank Dexia suddenly found it difficult to secure the funding. The risk of long queues of people waiting to withdraw their money became a major concern. Fortis turned out to have bitten off more than it could chew in its drive for growth and profit, undertaking acquisitions that were far too large. Confidence evaporated and suddenly the cry of distress rang out: 'Every man for himself!'

The banks' ultimate lifeline came in the form of taxpayer-funded rescue missions. Governments stepped in with loans, guarantees and so on – any means was acceptable to keep the financial system afloat.

There was no sign of a joint European approach. Each country tried to save its own banks and pull as many as possible out of the fire. After the massive firefighting operation came a moment of reflection: what was it in the banks' assets that allowed the fire to spread so quickly? Apparently, there was a great deal more than just savings and loans.

In the U.S., where the financial crisis originated, a huge pile of subprime mortgages came to light. Hardly anyone there had ever been concerned about them because the banks that had issued those loans had subsequently sold them on to other banks. Those buyers were not concerned either, as they in turn sold the packaged subprime loans on to other investors. And so it went on, until those bad loans eventually ended up in Europe. Our banks didn't suspect a thing either, because according to the credit rating agencies, the packaged loans were all of the highest quality. Nothing wrong with that! Until American households, en masse, were no longer able to repay their mortgages.

What else was on the banks' balance sheets? Debt. A huge amount of debt. Not just money from law-abiding savers, but a great deal of money that the banks had borrowed on the financial markets and from other banks. That's not a problem, unless your creditors no longer trust you. And it was precisely that trust that melted away like snow in the sun when the value of the subprime loans evaporated in the blink of an eye.

Whilst governments and central banks were putting out raging fires, traders were staring at the tips of their shoes. In their quest for returns, they had taken ever greater risks, but – with a few exceptions – they did nothing that was legally forbidden. Their bosses kept an eye on the

traders' activities, and if necessary, they kept only half an eye on them – so long as they hit their year-end bonus targets, all was well.

After the massive clean-up operation, a great deal of rubble remained. The banks' assets had largely become worthless, and the foundations of the largest banks, in particular, proved to be very shaky.

So who was actually responsible for that financial disaster?

## WHO WAS TO BLAME FOR THE CREDIT CRUNCH?

In the front row of the dock sit the top bankers, the faces who led the banks during their heroic conquest campaigns. They organised one takeover after another in their drive to become ever bigger – under the guise of economies of scale, with the accompanying bonuses.

In the U.S. in particular, the salaries of top bankers were many times higher than what the average worker earned – and their top salaries rose sharply as profits rose. That dangerous cocktail encouraged bankers to take ever greater risks. Their aim was to make a lot of money in the short term. The long term? 'Oh well, in the long run, we're all dead.'

Other bank staff often went along with the scheme. They too were promised high bonuses if they met their targets, which spurred them on to make as much profit as possible and thus to take risks.

Next in line is the board of directors. Normally, they are supposed to oversee the management, but clearly things went wrong there. Despite their often very generous remuneration, the board members did not oppose management's reckless plans. Nor did the (former) politicians on the board of directors. Maurice Lippens, the chairman of Fortis whose name was associated with the code of good governance, came under fire when the bank's communications were found to be at odds with reality.

What about the shareholders who elected the members of the board of directors? In many cases, they saw their financial assets go up in smoke. At shareholder meetings, frenzied investors demanded that heads should roll, but that did not help them to recover their losses.

Many shareholders had invested all their assets in a single bank because they believed that things could never go wrong. Reality proved otherwise. It never ceases to amaze that even seasoned and experienced investors flouted the first rule: never put all your eggs in one basket.

Their losses were often painful, but one must also dare to ask whether the shareholders were not indirectly responsible for the management taking so many risks. When American investment banks boasted of spectacular returns, their share prices peaked on the stock market. Because of this, management concluded that they were on the right track and that they needed to take even more risks to generate even greater profits. That dynamic continued until the financial system imploded.

Many Belgians, too, suddenly found themselves shareholders. Arco, the vehicle of the Catholic labour movement, had sold shares on the basis that they were safe. However, the money was invested in Dexia shares, and when those became virtually worthless, the Arco shares also lost almost all their value. Were the investors misled? Or were they simply too naive? That is a matter for lengthy debate. The only thing that is certain is that, despite all the promises made by politicians, many people were left with a nasty hangover.

## WHAT WERE THE CONSEQUENCES OF THE BANKING CRISIS?

There's no denying it: the credit crunch dealt a blow to people's confidence in banks. Suddenly, all the certainties of the past had vanished, as if we'd woken up in a different world. It wasn't that the world had changed; it was simply that the masks had come off. All the accused were lumped together. The pyre was ready: down with capitalism, down with the banks! There were loud calls to separate traditional banking activities from high-risk investment banking.

Heads had to roll. The investment bankers who had been strutting about so proudly for so long suddenly found themselves out on the street with a cardboard box containing a few personal belongings. Many top bankers received a 'kind request' to step down – though they were allowed to pop by the cash register on their way out. Many were given – and we're not making this up – a ridiculously high severance bonus as a thank-you for their efforts.

Axel Miller had helped drag Dexia into the abyss, yet upon his departure he received a round of applause from his staff – meanwhile, every Belgian had to still hope that Dexia's losses weren't too great, or the taxpayer might have to cough up even more money. From the smouldering ashes of Dexia emerged the state-owned bank Belfius, whilst what remains of Dexia has become virtually worthless on the stock market. The only task left for the management was to wind up the business as quickly as possible and with as little loss as possible.

The scandals that continued to emerge in the wake of the financial crisis did nothing to restore confidence in the banks. Several banks paid billions of euros in fines for having been complicit in money laundering. Investigations revealed that many banks were rather lax in their adherence to the rules and eagerly assisted their customers in setting up arrangements that could, at the very least, be described as dubious.

## WHAT PUNISHMENT DID THE GUILTY PARTIES RECEIVE?

The defendants were, unsurprisingly, found guilty. Their punishment? A whole host of new rules designed to prevent a repeat of the crisis. Since then, one word is emphasised time and again when it comes to banking: risk. All possible risks – market risk, operational risk, liquidity risk, systemic risk, and so on – must be measured. Banks must build up buffers to absorb potential losses. If they engage in trading activities, they must hedge against them.

A European banking union must ensure a level playing field for all and prevent competition between countries. The banking union ensures that all savers' deposits are protected up to 100,000 euros per financial institution, that large banks are supervised at the European level, and that banks in difficulty follow a set procedure.

The banks cannot simply get off the hook by accepting a whole host of new rules. They must also bear the consequences for the damage they have caused. In the past, they have already had to sell off many of their operations to reduce their risk and repay the governments – which often found themselves in trouble as a result. In addition, they must pay lots of taxes to compensate for the risk they represent. Smaller players who were not directly involved in the crisis are, unfortunately, being punished along with them. To curb the economic crisis, central banks resorted to printing money, and this quantitative easing caused interest rates to fall to an extremely low level.

Meanwhile, central bank interest rates have risen, allowing banks to earn more money again from their traditional lending activities, although the legacy of very low-interest-rate loans will continue to have an impact for some time. That is why banks are also looking for other sources of income. Alternatively, they are cutting costs by doing the same work with fewer staff, which once again generates bad publicity for the banking sector. The rise of AI has also already led to the announcement of a great many redundancies.

Digitalisation may be a solution, but it is a double-edged sword. Digitalisation has given rise to new competitors, mostly young tech start-ups that enable cheap and fast payments or offer services that sideline traditional banks. This wave of innovative financial apps is known as 'fintech'. In addition, the internet has made crowdfunding possible: companies no longer need to borrow from the bank but can just as easily appeal directly to the public.

Trendy tech companies do not even need to beg the bank for a loan. They can count on the enthusiastic support of private equity investors without having made a single euro in profit. Some start-ups, such as the Dutch digital bank Bunq or the Belgian firm Collibra, have grown into 'unicorns': young companies valued at over one billion dollars.

Meanwhile, traditional banks are facing direct competition from players who operate outside the regulatory framework: shadow banks. They manage billions beyond the reach of the regulators. Not only do they pose a threat to the banks, but they are also becoming an ever greater source of uncertainty for the entire financial system.

## **WILL CONFIDENCE IN THE BANKS EVER RETURN?**

Mistrust in the financial system is far from over; the crisis has left too deep a scar for that. Often, that mistrust is based on a lack of understanding. Unjustifiably so, really. The financial world, although it often resembles a jungle, is less dangerous than it appears from a distance. That is why financial literacy must become an essential part of the education of both young and old. We have to make financial decisions throughout our lives, so we'd better be well-prepared.

Not everyone realises that when you save for your pension, you are indirectly investing in the stock market, and that it is therefore in your best interests for the stock market to perform well. People understand that the stock market can be risky but often do not realise that you can limit that risk by diversifying your investments or investing in a mutual fund. Some investors are still misled by the promise of high returns and forget that higher returns automatically entail higher risk.

Only those who are well-informed about financial matters can invest their money with confidence.

## **IS ANOTHER BANKING CRISIS ON THE HORIZON?**

There is no doubt that another crisis is on the horizon. When will that crisis hit? No idea.

Why don't we know that? Because crises are, by definition, unpredictable. If we knew when a crisis would strike, we could take steps to prevent or mitigate its impact – although others might also try to use that information for financial gain. But we don't even know who or what will cause the next financial crisis. A trade war between China and the U.S.? A country unable to repay its debts? Any event could cause a breakdown in confidence so severe that it sends the financial world a crisis.

The mountain of new regulations for the banks does not rule out the possibility of another crisis – unfortunately. You can draw up as many rules as you like and try to measure everything, but banks are still run by people. People are fallible and make strange decisions that sometimes turn out well and sometimes don't. Richard Thaler investigated how psychology influences our behaviour and, consequently, the financial world. He won the Nobel Prize in Economics in 2017 for his insights.

Bankers were rightly in the dock, and they may well make the same mistakes again during the next crisis, but that is no reason to turn our backs on the financial world. We need to get to know the banks a little better, and what better way to do that than by stepping into a banker's shoes for a moment? That way, we'll learn what it means to set up and run a bank, by

discovering everything that's involved. Let's call it the Jangala Bank, which refers to the Sanskrit word for jungle.

We invite you to join us on this journey. We can't guarantee that you won't get lost now and then, but you'll be able to embark on this journey through the financial jungle with confidence. You'll realise more clearly than ever that the game is all about striking a balance between risk and return.

# CHAPTER I

## THE INTERMEDIARY FUNCTION

### WHY ARE FINANCIAL INSTITUTIONS NECESSARY?

If you set up a bank, there's a chance your name will go down in history. Just think of Alexander Baring, Nathan Mayer Rothschild or John Pierpont Morgan. In the distant past, each of them laid the foundations for financial institutions that enjoyed – or indeed still enjoy – worldwide renown.

The names Baring, Rothschild and Morgan continue to capture the imagination. They conjure up images of dynasties that exude wealth, opulence and power.<sup>1</sup> The banks they founded contributed significantly to shaping the world.

Can such a feat be repeated? Is there still room for new players in today's financial world, which seems to be growing ever more complex? It seems like a difficult journey through the jungle from which only a few emerge unscathed. Let's see if we can still pull it off and explore the path by setting up a new bank. If we manage to build our bank into a successful business, we might just make it into a footnote in some history book.

However, nobody sets up a bank simply to make a name for themselves and become famous. When you go into banking, you must first find a sound answer to the question of why people need credit institutions. Or to put it another way: why would customers come to your bank, and what services can you offer to win them over?

Let's look at that question from the perspective of a potential customer. Suppose Sam thinks he's found a gap in the market. He has an idea for a product that will take the world by storm.

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<sup>1</sup> Landes (2006, p. 380).

Unfortunately, he doesn't have enough money to simply start producing this miracle product. His savings aren't enough to buy machinery, recruit staff and advertise. So he needs to find some money.

But where do you find money?

Sam could approach people he knows to borrow money, such as his neighbour Sara, an elderly lady. Sam suspects she's quite well-off and could easily spare some money. But is Sara actually willing to help him out? Probably not.

When Sam reveals his plans, Sara will wonder whether it is wise to lend him money. After all, he will be inclined to paint a rosy picture of his project and exaggerate the potential of his miracle cure, whilst downplaying the risks. Sam knows the true state of his project, whereas his neighbour Sara does not. The fact that he has information that Sara does not have is known as information asymmetry.

If Sara is unaware of this phenomenon, she might be completely taken in by Sam's explanation and lend him money – something she might not do if she had the correct information. This is an example of adverse selection, which occurs when information asymmetry before a transaction leads one party (in our example, Sara) to make a decision based on incomplete or inaccurate information, increasing the likelihood of entering into an unfavorable agreement. If Sara is familiar with the principle of adverse selection, she will tell Sam that she cannot agree to his request and that he should pursue his brilliant idea elsewhere. If Sam continues to press for a loan, he will only serve to heighten Sara's suspicions.

Even if Sara is convinced of the potential of Sam's invention, she may wonder whether he will actually use the borrowed money to develop his product. Nevertheless, he goes off on a trip with it and she sees her investment go up in smoke. In this case, too, there is information asymmetry: Sam knows exactly what he intends to do with the loan, but Sara does not. This problem is known as moral hazard and may lead Sara to decide against lending Sam any money.

Disappointed and driven by desperation, Sam trudges back home. What now? Well, he can always go to a bank to ask for a loan – for example, the Jangala Bank.

Imagine a world without banks. Anyone who needs more money than they have would have to turn to friends, family and neighbours. That would be extremely cumbersome. Moreover, any debt that is not repaid, or not repaid in full, would lead to resentment or even arguments. Friendships would fall apart, family ties would be severed and protracted neighbourly disputes would arise.

That's why it's good that Sam can go to the bank. He hopes they'll take him on, because don't banks make their money by offering loans to customers? Why else do they exist? However, just because you're a bank doesn't mean that adverse selection and moral hazard aren't risks. It's just that a credit institution can minimise that information asymmetry.

# WHY DOES A BANK WANT SO MUCH INFORMATION ABOUT US?

To avoid the problem of adverse selection, banks distinguish between 'good' customers and 'bad' customers. They do this by gathering as much information as possible so that they can screen potential customers. Our bank will therefore ask Sam what his income is, how much money he intends to invest in his project himself, what his business plan looks like, and whether he has a financial plan demonstrating that he will actually be able to repay his loan.

Based on this information, the bank calculates a credit score (see also Chapters 7 and 8 on lending). This score will help determine whether Sam gets his loan or not. For Sara, it would not be at all worthwhile to screen Sam. Not only does this require a lot of time and energy, but there are also social barriers: for example, can you simply ask your neighbour to prove their income?

Another way in which the bank can reduce the risk of adverse selection is through signalling. In this process, Sam sends a signal that he is indeed acting in good faith. How does he do that? For example, by investing part of his own savings in his idea. In this way, he demonstrates that he believes in his project himself. By putting his own money on the line, he can convince the bank to grant him a loan.

George Akerlof, who won the Nobel Prize in Economics in 2001, was the first to describe how adverse selection hinders the efficient functioning of a market.<sup>2</sup> He illustrated this with the 'market for lemons'. Akerlof's metaphor is not about fruit, but about cars: in the U.S., a 'lemon' refers to a second-hand car that is faulty. Buyers are often unable to assess the quality of a car. A buyer does not know whether they are looking at a car that will run without problems (a 'peach') or one that will constantly break down (a 'lemon'). The price they are willing to pay is therefore the average price, namely somewhere between the price of a good car and the price of a bad one.

That is a clear case of information asymmetry, because the seller knows full well from their own experience whether their car is a lemon or a peach. If the car is indeed of poor quality, they will be happy with the average price the buyer is willing to pay, as that is higher than the lemon's actual value. If, however, the car is a peach, they know it is worth more than what the buyer is willing to pay. So they refuse to sell their car and would rather continue driving it themselves.

The consequence of adverse selection is that very few good second-hand cars come onto the market. Buyers are wary and certainly do not want to pay too much for a car that might be a lemon, whilst sellers of peaches do not get the price they want. As a result, the average quality of a car on the second-hand market is low. Since few people want to buy a lemon, there are few transactions. This explains why the market for second-hand cars functions poorly. (To be clear: Akerlof's paper was published in 1970, so he was referring to second-hand cars from the 1960s.)

Our bank will, so to speak, look under the hood of Sam's business plan and examine every component carefully. It also wants to get a sense of him personally: does he have a lot

2 Akerlof (1970).

of driving experience, or is he a reckless driver? By asking questions, the bank can reduce the information asymmetry.

Then there is the issue of moral hazard. Our bank wants Sam to actually use the borrowed money for its intended purpose, namely to develop his miracle product. So we'll monitor Sam: we'll ask for a guarantee or only release the funds once he can provide invoices. This, too, is a way of limiting information asymmetry, and a credit institution can do this more easily than an individual. Friends and family are unlikely to ask for a guarantee, as doing so would imply that they do not trust Sam.

Nevertheless, a bank also wants a good relationship with its customers, as this helps just as much to reduce information asymmetry. Relationship banking means that the bank invests in long-term relationships. Both the bank and the customer benefit from this. If Sam were already a customer at our bank, we would incur far fewer costs for screening and monitoring when he next applies for a loan, as we already have an insight into his history as a customer. If the bank knows Sam and trusts him, he can obtain a new loan more easily, presumably even at a lower interest rate. Moreover, by building a good relationship with its customers, a bank can prevent them from switching to competitors.<sup>3</sup>

## WHO BENEFITS FROM THE EXISTENCE OF FINANCIAL INSTITUTIONS?

We return once more to Sam, who knocks on his neighbour Sara's door. He has convinced her that his idea will be a commercial success and that he has no intention of using her money to book some luxury holiday. She is willing to lend him a tidy sum from her fortune. Sara is a sensible woman, so she asks him to put a few things on paper, so that there is no row later on. Things that must definitely be included are the amount borrowed and the terms of the loan, such as the timeframe within which she will get her money back and any interest.

To be absolutely certain, she has the contract drawn up by a solicitor, after which both parties sign it. However, solicitors are expensive, even compared to bankers, and the high cost of drawing up such a contract might still deter Sara from lending Sam money. Sam might say: 'All right, I'll pay that cost.' But then he would be paying the solicitor with borrowed money, and he would no longer be able to invest that money in his product. In doing so, he would be putting himself at a disadvantage.

For our credit institution, the high cost of drawing up a legally binding contract is not a problem. We might pay a very large sum of money once to draw up such a document, but we can then reuse it multiple times. If our bank has a standard contract signed by several thousand customers, the cost per customer is negligible. Charging each customer a small administrative fee is sufficient.

3 Boot & Thakor (2000).

There is another reason that might prevent Sara from lending Sam money: a lack of risk diversification. Even if she believes in his project and his good intentions, it could still fail. If Sara lends a large portion of her savings to a single person and his project goes wrong, for whatever reason, that automatically means a significant loss for Sara. The fact that her risk is concentrated on a single counterparty may lead her to refuse to lend money to Sam.

Our bank, too, runs the risk that a customer might not repay their loan. However, a credit institution has many customers and can therefore spread its risk across a large number of loans. If the bank has carried out its screening properly, most projects will go according to plan. It is no disaster for our bank if something were to go wrong with Sam's project: unlike Sara, we do not put all our eggs in one basket. The fact that a bank can spread its risk also means that Sam can more easily obtain a loan from a bank than from his neighbour if his plan is sound.

Our Jangala Bank actually acts as an intermediary: we stand between the Sams and the Saras of this world. As an intermediary, we can reduce or even resolve the problems of information asymmetry, high transaction costs and a lack of risk diversification. After all, if our bank is successful, we will have many customers like Sam and Sara. People with a surplus of money receive a return – for the time being, at least – when they deposit their money with us. People who are short of money can borrow from us and pay a fee for doing so.

Our role as an intermediary creates a system of indirect financing. Savers do not lend their money directly to borrowers, but do so indirectly, through our intervention. By depositing her money with the bank, Sara's money may still end up with Sam, although she is unaware of this. Equally, her money may be used to finance another loan.

To provide an overview of all the money we receive from customers and what we do with it, our bank draws up a balance sheet. This consists of an assets side and a liabilities side.<sup>4</sup> The liabilities side shows where our money comes from, namely from shareholders and creditors. The assets side shows what our bank does with that money. This means that the assets and liabilities sides in our accounts must always be equal in value, otherwise money would have miraculously disappeared or appeared somewhere.

Since savings are our source of funding, our bank has a debt to savers. We must be able to return that money to them at any time, which is why savings are placed on the liabilities side of the bank's balance sheet. The loans we grant – in other words, how we use those savings – are placed on the assets side. Customers who borrow money are obliged to repay those loans to us.

4 Note that, in what follows, the liabilities side refers to the full right-hand side of the balance sheet, including both shareholder's equity and liabilities.

# WHAT ARE THE BENEFITS OF INTERMEDIATION?

As an intermediary, Jangala Bank converts savers’ money into loans. In doing so, we solve some of the problems that Sam and Sara faced when they tried to reach a direct agreement.

To begin with, intermediation involves a transformation: the often relatively small amounts that savers deposit with our bank are converted into loans for much larger sums. If Sam is planning a really large investment, Sara’s savings alone will not be enough. Similarly, when someone applies for a loan to buy a home, the amount involved is often much greater than what a single person has saved.

There is also a transformation in terms of the duration. If Sara were to lend directly to Sam, she would only want to be without her money for a limited period, whilst Sam would prefer to use and repay the loan over a longer term. Similarly, the term of a mortgage is often much longer than the period for which a saver is willing to entrust their savings to us. As a bank, we therefore convert short-term savings into long-term loans. This creates a liquidity problem, because our bank must always be able to return customers’ savings to them when they ask for it – we’ll come back to this later.

Finally, intermediation transforms the risk. If Sara lends her money to Sam, all her risk is concentrated on a single person. If Sam’s project fails, there is a high chance that Sara will lose her money. However, because we, as a bank, provide loans to a great many different projects, the risk is spread, meaning that savers need not fear suddenly losing their savings. If a company goes bankrupt or a customer fails to repay their loan, the saver will not be affected. Moreover, the bank can draw on far greater experience and expertise than someone lending money to a friend or neighbour on their own. In this way, the bank can minimise the problem of information asymmetry.

The benefits of intermediation stem from the bank’s economies of scale. By drawing up standard contracts for many customers and by building up experience in selecting and monitoring customers, we are able to reduce the cost per transaction. The greater the economies of scale, the lower the costs and the more profit the bank can make. This pursuit of economies of scale is a key driver for banks to merge and create larger banking groups. Large financial groups have also been formed in Belgium. KBC, for example, was created through the merger of Kredietbank, ABB Verzekeringen, and Cera Bank.

Through its role as an intermediary, our bank creates benefits for all parties involved – not only for savers and borrowers, but for society at large. Savers benefit from the fact that their savings remain liquid and are therefore easily accessible. At the same time, their risk is limited, as the bank has spread the money across a large number of different borrowers. When customers invest their money in the standard products offered by the bank, transaction costs are also kept to a minimum. The bank offers only a limited number of products, so that customers can maintain an overview and are not put off.

Borrowers also benefit from lower transaction costs. Moreover, they borrow at a lower interest rate than if they were to borrow from a single individual. In addition, the bank provides financing when they need it, and for larger sums, which are also available for longer periods. Access to borrowing enables individuals to absorb temporary income shocks and smooth their consumption over time.

For society as a whole, the existence of financial intermediaries has the advantage that savers’ money is made available to borrowers in an efficient manner. This leads to a high level of saving and borrowing activity, which is good for the economy. If everyone kept their money under their mattress, entrepreneurs would have too little money available to invest in their businesses and families would be unable to buy a home. Furthermore, a bank can also finance high-risk investments with the potential for high returns, as its scale allows it to spread the risk.

# WHY DO WE STILL NEED BANKS NOW THAT CROWDFUNDING EXISTS?

There are very good arguments for setting up your own bank, but we must not lose sight of the fact that Sam is a young start-up entrepreneur with probably few guarantees. As a result, our Jangala Bank would be reluctant to grant him a loan, so Sam would have to look elsewhere for funding.

As such, he can opt for crowdfunding. In doing so, Sam is raising funds directly from a crowd – that is, a large number of small contributors. Initially, crowdfunding made the news as a way for charities to raise money from the public. Meanwhile, an increasing number of companies are also using crowdfunding as a source of funding. The amount raised through crowdfunding in Europe – estimated to reach 4.25 billion euros by 2025<sup>5</sup> – will, however, remain modest compared with the funds held in European savings accounts and the total volume of bank lending.

If he wishes, Sam can submit his funding application to a crowdfunding platform. If that organisation approves his application, it will publish his proposal on a website so that interested parties can back it. A crowdfunding platform in the European Union is, thanks to the ‘Crowdfunding Regulation (Regulation 2020/1503)’<sup>6</sup> authorised and supervised by national supervisory authorities. In Belgium, this supervisory authority is the FSMA (the Financial Services and Markets Authority). At the European level, the European Securities and Markets Authority (ESMA) ensures regulatory consistency by coordinating national regulators and maintaining the public register of authorised crowdfunding service providers. If the amount Sam wishes to raise is less than 5 million euros, he is not required to draw up a prospectus; an information memorandum containing key details about the offer is sufficient. If he raises less than 500,000 euros

5 ESMA (2025).

6 Regulation (EU) 2020/1503.

and each investor can contribute a maximum of 5,000 euros, that information memorandum is not even required.<sup>7</sup>

Spreds and Look&Fin are examples of alternative financing platforms that operate via crowdfunding. Traditional banks can also organise crowdfunding campaigns. If our Jangala Bank is licensed to do so, we will be able to set up our own crowdfunding platform, just as KBC did with Bolero Crowdfunding.

If Sam opts for crowdfunding, he must be fully aware that there is no guarantee he will actually raise the amount he is seeking. Although the rules for platforms have become stricter, the ESMA emphasises that a project can still fail and therefore entails risks.

If that risk does not deter him, Sam can choose between offering bonds and issuing shares. If he opts for bonds, he is taking out a loan from the public. In return, investors receive annual interest and, at the end of the term, they get their invested amount back. Loan-based crowdfunding projects, also known as crowdlending, were by far the most popular and numerous in 2024. More than 10,000 such projects were offered in the EU, with over 5.5 million investors taking part.<sup>8</sup>

Start-ups favor crowdlending to fund initial growth or product development, and Sam is also a start-up entrepreneur, so that makes sense. However, because this type of investment carries greater risk than a traditional loan to an established company, Sam is required to pay a relatively high interest rate. The average annual return for investors in European crowdlending campaigns is around 7 per cent, which is significantly higher than the interest rate a bank charges to companies that have been in business for some time.

Sam could also choose to issue shares via equity crowdfunding. This once again raises the issue of information asymmetry. Sam may have a better understanding of the true value of his company's shares than external investors. He might think his company is a 'peach', whilst some investors fear they are buying a 'lemon'. As a result, they will be willing to pay less than he has in mind.

As a result, Sam, like many other entrepreneurs, prefers to finance projects with cash where possible, such as his own savings. He then turns to debt financing via loans or bonds. Only as a last resort does he choose to issue shares. We refer to this typical sequence of financing as the pecking order theory.<sup>9</sup>

This theory already provides some indication of how successful companies are: companies that rely on equity crowdfunding tend to be less profitable than similar companies that tap into other sources of funding.<sup>10</sup> They have less cash and more debt, leaving them with no room to take on new debt. The risk of adverse selection increases, and so does the likelihood of the company going bankrupt.

On average, 50 per cent of companies that have ventured into equity crowdfunding campaigns go bankrupt within the first three to five years.

7 Wet van 11 juli 2018.

8 ESMA (2025).

9 Myers & Majluf (1984).

10 Walthoff-Borm, Schwienbacher, & Vanacker (2018).

A study of German equity crowdfunding campaigns revealed that the probability of failure after eight years was in fact over 63 per cent.<sup>11</sup>

These figures are considerably worse than those for standard or traditional crowdfunding. Although some assume that the 'wisdom of the crowd' ensures that only sound companies raise funds via equity crowdfunding, it appears that there are more bankruptcies amongst such companies than amongst similar enterprises that raise fresh capital through other financing mechanisms.<sup>12</sup>

Investing in a crowdfunding campaign therefore carries considerable risks. It is not an option for savers who prefer not to take on too much risk. If our bank were to set up a crowdfunding platform, it would be important to keep the number of companies failing to a minimum if we are to avoid losing our credibility.

Nevertheless, it is wise to keep an eye on these new forms of financing. Companies that do not yet meet our criteria for obtaining credit at the time of their crowdfunding may well become potential customers if they subsequently prove to be successful. By supporting them as start-ups, we build a privileged relationship with such companies. If, following a crowdfunding campaign, Sam's business grows into an established company, he will turn to us first for a loan if Jangala Bank has provided him with good guidance right from the start.

11 Reichenbach & Walther (2021).

12 Walthoff-Borm, Vanacker, & Collewaert (2018).

# CHAPTER 2

## FINANCIAL INSTITUTIONS

### DO ALL FINANCIAL INSTITUTIONS DO THE SAME THING?

Now that we know it does indeed make sense to set up our Jangala Bank, we need to ask ourselves what services we will offer and what sort of customers we want to attract. After all, the financial landscape is diverse and there are many different types of institutions, each with their own characteristics. For example, credit institutions all provide credit, yet they can differ significantly from one another in terms of the type of credit they offer or the customers to whom they grant that credit.

In addition, there are many other players offering financial services to both private individuals and businesses. These include investment firms and insurance companies.

### WHAT DOES A CREDIT INSTITUTION DO?

Let's start with credit institutions. Under Belgian law,<sup>13</sup> a credit institution is defined as 'a Belgian or foreign undertaking whose activities consist of accepting cash deposits or other repayable funds from the public and granting loans on its own account'. Despite the technical language, the essence is clear: a bank acts as a financial intermediary, accepting savings from depositors and re-allocating these funds to borrowers in the form of loans, as we described in the previous chapter.

Within the group of credit institutions, savings banks, for example, are distinct from securities banks. In the past, that distinction was much more significant; now it is mainly a way of distinguishing themselves. By positioning itself in the market as a savings bank, a credit institution can indicate that it specialises in services for private individuals, such as collecting

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<sup>13</sup> Wet van 25 april 2014.

savings and granting mortgage loans. A securities bank emphasises that carrying out stock market transactions is one of its core activities.

Whilst ‘ordinary’ banks used to target businesses primarily and savings banks mainly targeted private individuals, that distinction has now largely disappeared. The trend by which financial institutions offer similar services and appeal to the same target audience is often referred to as ‘blurring of industry boundaries’.

This blurring of industry boundaries is not only evident between different types of credit institutions, but also amongst financial institutions in general. For example, it is beneficial for a credit institution to offer insurance products alongside its traditional banking products. When a couple approaches our Jangala Bank for a mortgage, we can suggest that they take out fire insurance or life insurance at the same time.

This enables us to achieve economies of scope, whereby offering two complementary products together is less costly than providing them separately. A great many credit institutions are taking this approach. When a credit institution also engages in activities in the insurance sector, we refer to this as bancassurance or allfinanz. Conversely, when an insurance institution offers banking products, we refer to this as assurfinance.

The fact that the blurring of industry boundaries has continued apace in recent years is a consequence of the trend towards deregulation or liberalisation. Indeed, many restrictive rules in the financial sector were relaxed or abolished in Europe during the period 1985–1995. For example, as a result of the Second European Banking Directive,<sup>14</sup> banks in Belgium were permitted to sell insurance, provided this was done through a subsidiary.<sup>15</sup> In 1992, that Second European Banking Directive also established a formal definition of banking activities and introduced the model of the universal bank.

## WHAT IS A UNIVERSAL BANK?

In the universal banking model, a bank can offer a wide range of services and cater to different types of customers. This means that many financial institutions are diversified groups, also known as conglomerates, with a complex organisational structure. This gives rise to financial services groups, such as the KBC Group, headed by a financial holding company.

Financial holding companies use their investors’ money to acquire stakes in numerous companies with the aim of controlling them. In the case of banking groups, this often means that a single parent holding company brings together the various divisions. Each subsidiary has its own specialism, whilst the group presents itself to the customer as a single entity.

If we were to apply that universal banking model to our Jangala Bank, we would need an organisational structure that allows us to carry out all these different activities whilst still maintaining central control. Put simply, it might look something like this:

14 Council Directive 89/646/EEC.

15 Gual (1999).

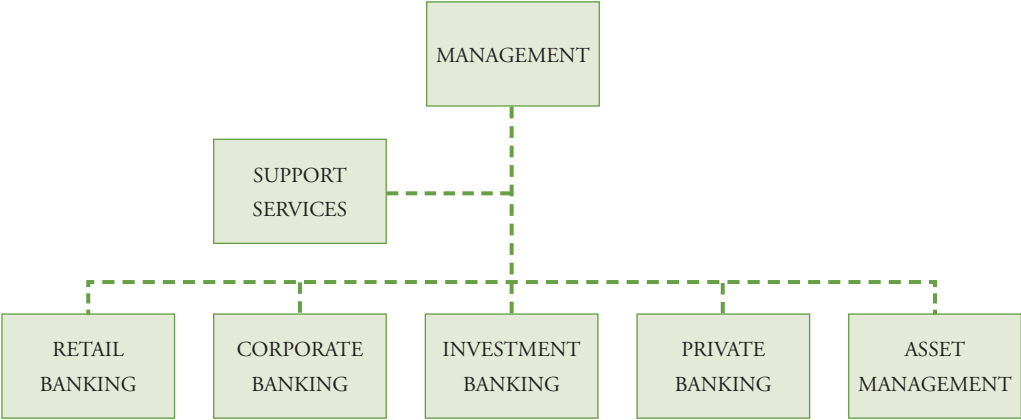


Figure 1: Organisational structure of the universal Jangala Bank

In this diagram, our Jangala Bank consists of five segments or divisions. Firstly, there is retail banking, which encompasses all activities aimed at private individuals, such as organising payments and providing loans for consumer goods or housing. Next is the corporate banking division. This division provides services to businesses, such as the processing of payments, cash management and the granting of loans. A third division deals with investment banking. Its main role is to assist large companies and governments with the issue of shares and bonds. Investment bankers also advise on mergers and acquisitions and trade on the financial markets.

The private banking division provides banking and investment services to high-net-worth individuals. The final sector, asset management, specialises in creating and managing funds for private individuals and professional investors.

We will discuss each of these sectors in more detail in the following chapters.

Having examined the structure of Jangala Bank, we can now turn to a broader question: how many banks operate in Europe?

When we look at the evolution of the number of banks, we see some notable trends. For example, the number of banks established in the EU 27<sup>16</sup> fell from 9,044 in 2001 to 4,834 in 2024.<sup>17</sup>

16 Since Brexit (31 January 2020), the European Union has consisted of 27 Member States (EU 27).

17 European Banking Federation (2025).



Figure 2: Number of banks in the EU  
 Source: The European Banking Federation (EBF), ECB

There are several reasons for this sharp decline. Many banks merged or were taken over to become larger and more efficient. Following the financial crisis of 2007–2009 and the precarious state of public debt in Southern Europe between 2010 and 2012, many banks faced difficulties. As a result, many savings banks and cooperative banks were either closed or merged. Stricter regulations too – such as Basel III, which we will return to later – made economies of scale necessary. Furthermore, the environment of exceptionally low interest rates until the early 2020s put pressure on banks’ profitability and led to consolidation within the sector.

# WHAT OTHER FINANCIAL INSTITUTIONS EXIST ALONGSIDE CREDIT INSTITUTIONS?

All banks are financial institutions, but not all financial institutions are banks in the traditional sense. Take, for example, an investment firm. Belgian law defines such an investment firm as ‘an undertaking which, on a professional basis, offers one or more investment services to third parties and/or carries out investment activities’.<sup>18</sup> It is therefore not aimed at customers who wish to save, but at customers who wish to invest their money in products other than a savings account.

Investment firms specialise in receiving and transmitting orders for financial instruments, in investment advice and in ancillary activities such as research. An investment firm may also operate a multilateral trading facility (MTF). This is an electronic platform through which

18 Wet van 6 april 1995.

professional investors carry out buying and selling transactions. MTFs are therefore direct competitors to traditional stock exchanges such as Euronext.<sup>19</sup>

As with banks, we have also seen a very sharp decline in the number of investment firms in recent years. In 2024, there were more than 4,600 firms active in Europe. Due to significantly increased regulation, a great many mergers have also taken place in this sector.<sup>20</sup>

In addition to investment firms, a whole host of other institutions fall under the supervision of the National Bank. These include management companies of collective investment schemes.<sup>21</sup> Such collective investment schemes pool money from retail investors to invest it in financial instruments.<sup>22</sup>

Then there are insurance and reinsurance undertakings. When an insurance undertaking<sup>23</sup> enters into an insurance contract,<sup>24</sup> it agrees to provide a specified benefit if an event occurs that the policyholder or beneficiary seeks to protect against.

That benefit may involve the payment of a sum of money or the provision of a service. In return, the policyholder pays a fixed or variable insurance premium.

A reinsurance company is a company that assumes risks from other insurers. It is therefore an insurer for insurers, as they wish to protect themselves against having to pay enormous sums should a disaster occur, such as a major factory fire or flooding. Well-known examples of reinsurers include Munich Re and Swiss Re.

Financial institutions that play an important, yet often overlooked, role are settlement and clearing organisations. They are responsible for holding securities – a process known as custody – and guarantee to buyers and sellers that a transaction is carried out correctly, a process known as clearing. In addition, they ensure that buyers and sellers receive their securities and their money respectively, a service known as ‘settlement’. Examples of such companies include the Bank of New York Mellon and Brussels-based Euroclear. They play a crucial role in the execution of transactions, as evidenced by Euroclear’s figures. In 2022, the company reported a net profit of 1,112 million euros, and the total value of the securities it held stood at 43.6 trillion euros at the end of 2025.<sup>25</sup>

Then there are also the guarantee companies. These cooperative companies aim to facilitate access to credit for their members, such as self-employed entrepreneurs.<sup>26</sup> They do this by acting as guarantors for the liabilities of their members. They complement the guarantees provided to banks, which are often issued by regional or federal governments. They exist in various European countries, often with their own specific characteristics and objectives. In Spain, there are around

19 Wet van 25 oktober 2016.  
 20 EFAMA (2025).  
 21 Wet van 3 augustus 2012.  
 22 See Chapter 18, Asset management.  
 23 Wet van 13 maart 2016.  
 24 Wet van 4 april 2014.  
 25 Euroclear (2025, p. 100).  
 26 Koninklijk Besluit van 6 augustus 1999.

18 ‘Sociedades de Garantía Recíproca (SGR)’; Italy has its ‘Confidi’; and France has its ‘Sociétés de Caution Mutuelle (SCM)’ – five cooperative guarantee societies.

Finally, we must discuss payment and electronic money institutions. They specialise in payment services or in the development of payment instruments.<sup>27</sup> We have seen a great many new developments in this area in recent years. These present opportunities for financial institutions, but at the same time they can pose a significant threat to the current banking sector.

## WHAT ARE THE THREATS TO TRADITIONAL BANKS?

Jangala Bank must take into account two major trends that are shaping the future of the banking sector. Firstly, there are the enormous technological developments and, secondly, increasingly stringent regulation. Many new technology companies are developing financial apps or services that meet needs where traditional financial players fall short. We refer to this new, highly diverse sector as fintech, a contraction of ‘financial technology’.

Although innovation has always been a key feature of the banking sector, it is now taking place on an unprecedented scale and at an unrivalled pace. This is particularly evident in two areas: crowdfunding, which we discussed in the first chapter, and blockchain, the technology behind cryptocurrencies such as Bitcoin and Ethereum. In crowdfunding, new intermediaries are replacing the bank; blockchain, on the other hand, renders intermediaries completely redundant.<sup>28</sup>

Fintech companies are also highly visible in the field of payments. Young technology start-ups are developing apps that enable both individuals and businesses to make payments more quickly and efficiently. The platform of the Dutch company Adyen, for example, processes payments regardless of the method or device used. Adyen counts major names such as Uber and Microsoft amongst its clients and was successfully listed on the Amsterdam stock exchange in June 2018.

In recent years, a great many fintech companies have also been set up that focus on the ‘buy now, pay later’ market. Start-ups such as Klarna, Afterpay, Affirm and Zip enable customers to place orders online but defer payment until a later date. Merchants receive the money quickly from Klarna, which charges them a fee for this service. This rapidly growing market has also led to unprecedentedly high valuations. In early 2022, Klarna was even valued at 45 billion dollars, making it one of the most valuable fintech companies in Europe. Due to, amongst other things, rising interest rates and the avoidance of risky tech companies, Klarna’s valuation fell to 6.7 billion dollars in early July 2022.<sup>29</sup> In the years that followed, it cut costs, enabling it to turn

27 Wet van 11 maart 2018.

28 Cai (2018).

29 Neiryndck (2022).

a profit for the first time in 2024. This led to an initial public offering on the New York Stock Exchange at a valuation of 15.1 billion dollars.<sup>30</sup>

Mobile banks, such as Revolut, N26, Monzo and Bunq, are also emerging. As they do not have expensive high-street branches, they can offer their services cheaply and in a user-friendly way. The founders of N26 were the first to launch a bank account within an app, in collaboration with Wirecard. The account is free, as are cash withdrawals in euros and payments in any currency. The company generates revenue from, amongst other sources, commissions on payments processed through online shops. They are currently active in 24 countries.<sup>31</sup>

This development poses major challenges for all existing banks and raises the question of what the future of the banking sector will look like. A survey by the National Bank of Belgium shows that most banks are opting to digitise and modernise even further in order to improve customer relations.<sup>32</sup> Another possible scenario is that existing banks will limit themselves to their core activities, whilst fintech companies provide very specific services. As a result, many banks are partnering with fintech start-ups. For example, Euroclear has joined forces with Liquidshare, which provides services to SMEs based on blockchain technology.<sup>33</sup> KBC is working with Cashforce and BrightAnalytics to improve data management for its SME clients.<sup>34</sup>

Fintech is not the only threat to the current banking model. In recent years, numerous other shadow banks have emerged. These are institutions that act as intermediaries and provide loans but are not subject to regulatory oversight. Examples include funds or specially established investment vehicles that are not financed by deposits but instead through short-term instruments in the financial market.

The sums managed by such shadow banks are substantial. At the end of 2020, the global total was estimated at 76.3 trillion dollars,<sup>35</sup> meaning that they pose a significant risk to financial stability.<sup>36</sup> Shadow banks have seen strong growth in the U.S., gaining market share particularly in states where banks were subject to stricter regulations and where borrowers’ creditworthiness is lower. In the U.S., around 65 per cent of mortgages were granted by NBFIs (non-bank financial institutions) in 2024.

Unlike traditional banks, shadow banks sell almost all the loans they grant to other investors on the secondary market.<sup>37</sup> This has resulted in the ‘originate-to-distribute model’<sup>38</sup> where financial institutions grant loans, package those debts and sell them as investments.

Rather than ensuring that they only lend to ‘peaches’, shadow banks have no qualms about lending to ‘lemons’ as well. The loans are resold anyway, and the associated risk is passed on to

30 Forbes (2025).

31 Sprout.nl (n.d.).

32 Bégasse de Dhaem, Bodequin, Romont, & Van Gastel (2018, p. 11).

33 Euroclear (n.d.).

34 Anonymous (2019).

35 The figures relate to 29 jurisdictions that account for more than 90 per cent of global GDP.

36 Financial Stability Board (2025, p. 91).

37 Buchak, Matvos, Piskorski, & Seru (2018).

38 Berndt & Gupta (2009).

the buyer. If that buyer does not exercise due care or relies too heavily on the judgement of the credit rating agencies, they will face significant losses when a whole host of ‘lemons’ are unable to repay their loans. This, then, is the story of the credit crunch, in which everyone was granted a loan, even those with no income.

In Europe, too, shadow banking is on the rise, with total assets held by investment funds and other financial institutions (OFIs) estimated at 50.7 trillion euros, 20 per cent more than all the assets held by banks.<sup>39</sup> Based on figures from the end of 2024, 23 per cent of loans to non-financial corporations in Europe are provided by shadow banks.<sup>40</sup> Their scale, and the fact that such institutions are often subject to less supervision and regulation than conventional banks, means they pose a potential risk to the financial system. If we are to avoid any further surprises, we would do well to keep a close eye on this trend.

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39 European Systemic Risk Board (2018, p. 75).

40 European Systemic Risk Board (2025, p. 77).

## CHAPTER 3

# SETTING UP A BANK

### WHAT CONDITIONS MUST YOU MEET TO SET UP A BANK?

We have a long way to go before Jangala Bank can open its doors. After all, you cannot simply start carrying out banking activities; you need a licence to do so. You apply for this licence from the regulator. In most European countries, this will be the national bank.

Such an application is no mere formality. You must submit a comprehensive application, and the regulator’s requirements are very wide-ranging. These requirements cover, amongst other things, the initial capital, the legal form, the shareholders, and the composition of the management and the board of directors. The National Bank assesses our application on all these different points and then decides whether we will be granted our licence – or not.<sup>41</sup>

### HOW MUCH CAPITAL DO YOU NEED TO SET UP A NEW BANK?

Anyone who wants to become a banker needs money. A lot of money. To set up a bank in Belgium, you must have capital of at least 6.2 million euros, which is more than the 5 million euros required by the European directive.<sup>42</sup> However, the National Bank may also impose stricter requirements. For example, the National Bank required the new cooperative bank NewB to raise an additional 30 million euros in capital before it could be granted a banking licence.<sup>43</sup>

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41 Wet van 25 april 2014.

42 Directive 2013/36/EU.

43 Adriaen (2019).