Blockchain to cut bank values by 30%

- By Elizabeth Fry

Melbourne-based boutique credit fund Realm Investment House said block chain technology could knock bank book values down by as much as a third over the next 5 to 7 years.

Like most investors, Realm accepts that distributed ledger technology, combined with the digitisation of currency, could disrupt Australian bank business models.

Accordingly, the fund developed its own "model" to track the potential for blockchain and other emerging technologies to dent bank franchise values.

The theory is simple. Basically, by assuming an increase in cost of household deposits - that cannot be passed to customers in a blockchain world - Realm was able to model a sizeable decline to bank book values.

“This increased competition forcing banks to bear more costs is something that we see as contributing to the decline in their franchise values,” noted Realm analyst, Myron Ithayaraj.

“If the possibility of different ledgers being able to trade and exchange value between themselves and the real economy becomes a reality, there is potential for a big increase in the mobility of capital,’ he noted,

Threat to bank valuations

Ultimately, he believes that technology is likely to increase client contestability, which translates to higher churn rates which will, in turn, reduce the premium on incumbency.

“If deposits are held in digital wallets, we get a scenario where the cheapest and stickiest money in the system now becomes highly contestable.

“Again, this could alter the landscape of Australian banking with balance sheets potentially transformed.

“Clearly, if the banks need to incentivise customers to act, the impact to the average cost of securing household deposits could rise significantly. At the same time, if it’s easier to move your loan, the ability to pass on costs to end borrowers will decline.”

While the analyst expects that blockchain will effectively reduce monopolistic power and cut the premium of incumbency, the real question is when and by how much.

According to Ithayaraj, the threat is credible, albeit not immediate.

In his view, widespread acceptance of the disruption story for banking - a’ la the Amazon in retail - is likely to take place prior to any tangible financial hit to bank bottom lines.

Bank vulnerability to increased transparency is borne out by the Reserve Bank of Australia’s submission to the competition watchdog which speaks to how a collection of inefficiencies act to protect incumbency.

Enterprise Values

Here, the central bank noted that the great contraction in bank margins came with deregulation, which genuinely increased market competition.

“This in turn leads to the question of how bank margins would be squeezed in an environment where technology has proceeded to the point where clients can be highly mobile and choose product components across various providers.”

To underline his point, the big four banks maintain the highest proportion of mortgages to balance sheet and the largest percentage of household deposits to total liabilities.

This directly translates to higher ROE’s which in turn are rewarded by the market through higher price to book multiples.

“Blockchain looks to disrupt the core of these operations by creating efficiency and reducing costs.

“In such a world, the dependency on banks and financial institutions will be questioned and their balance sheets scrutinised.”

What does it mean for credit investors?

No one of course knows when and how big disruption will be when it happens.

To the Realm analyst, dealing in credit is ultimately the practice of calculating what a fair premium looks like for uncertainty.

From where he sits, the efficiencies the blockchain promises is a catch 22 for the financial sector and rent-seeking behavior within banking more generally.

The Realm analyst pointed out that taking a view here doesn’t necessitate avoiding hybrids, or bank tier two assets, or indeed bank equity.

However, he added, it does raise the question of what is a fair price?

On hybrids, he is telling investors to consider maximum conversion numbers which translate to base equity values, especially for securities with call dates that are more than 5 years from today.”

But he has not dismissed the idea of alternative scenario where the banks collectively create a private blockchain for the sector.

“Having private blockchains allows the processing nodes (miners) to be governed and regulated yet still capitalise on the efficiency and transparency of the technology.

“However, all scenarios result in an increase in efficiency and transparency – characteristics that are negative for rent-seeking behavior.”

https://www.rfigroup.com/australian-banking-and-finance/news/blockchain-cut-bank-values-30