Factsheet on bank structure reform

Structural reform of large universal banks makes good economic sense:
- Separating credit from trading could reduce the cost of credit to the real economy.
- It would improve financial stability, by ending a subsidy that distorts financial trading.
- It would bring real competition to capital markets, benefiting SMEs and strengthening the single market.

To achieve these benefits, structural reform at large universal banks must separate all trading, including market making and derivatives, from deposit banking. Separating only proprietary trading, as some countries prefer, will bring little economic benefit.

Nonsense	Sense	Evidence
	Cost of credit	
Structural reform would harm the ability of universal banks to transform and channel capital flows to where they are most needed in the economy.	Large universal banks lend proportionately less of their balance sheets to the real economy than smaller banks, and devote more assets to trading. Separation would reduce the incentives for them to do this.	In March 2012, loans to non-financial corporations and households only made up 28% of the aggregate balance sheets of EU monetary financial institutions (HLEG, based on ECB data http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf) The loan books of the 10 smallest EU listed banks represent 75% of their total assets. By contrast, lending by the 10 largest listed banks represents only 36% of their total assets. (AlphaValue analysis cited in FW 1 Jun 2012 HLEG submission http://www.finance-watch.org/ifile/Publications/Responses/120601-Finance-Watch-response-to-consultation-on-EU-banking-structure.pdf)
	Any increase in funding costs for the separated trading entity would reflect the removal of risk from the deposit taking entity. Other things being equal, this should lower the cost of funding for the deposit bank, from which most real economy lending is made.	"The separation will lead to ratings downgrades of several notches" for the trading entity (ISDA/AFME joint submission to EC http://ec.europa.eu/internal_market/consultations/2013/banking-structural-reform/contributions_en.htm) EU banks received credit upgrades of up to 4.5 notches up to 2012, with an average for six large EU banks of 3 notches (HLEG, p23 and 63). In 2010, this funding advantage was worth an annual EUR 3.8bn-24bn per bank for the four largest banks in each of Germany, France and the UK (nef, 'Quid prop quo', table 9 http://www.neweconomics.org/page/-/files/Quid_Pro_Quo.pdf). "For UK banks, the average annual subsidy for the top five banks between 2007 and 2009 was over £50 billion - roughly equal to UK banks' annual profits prior to the crisis" (BoE http://www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf).
	Large universal banks are more likely to reduce real economy lending after a financial crisis because their higher dependance on wholesale funding gives them a greater exposure to wholesale market shocks.	Large universal bank balance sheets have around 50% overall dependence on wholesale market funding. Their loan books, taken alone, use only around 15% wholesale funding. The universal banking structure therefore triples the loan book wholesale market exposure (HLEG data, p.127, cited in FW response to EC consultation on HLEG, Nov 2012 http://www.finance-watch.org/ifile/Publications/Responses/121113_Answer_to_EC_Consult_Liikanen.pdf). "Tight funding conditions inhibit lending operations, particularly because European banks are dependent on short-term wholesale funding" (World Bank www.g20.org/load/781245823) EU banks continue to delever after the crisis: In the year to Sep 2013, Eurozone financial institutions reduced their loans to non-financial corporations by 3.5% http://blogs.ft.com/the-a-list/2013/11/05/what-to-do-with-the-eurozone-banking-system/#axzz2jqtOXuUU
Europe's banks overall have fewer deposits than loans, so it is "unlikely" that deposits are used to fund trading (EBF, citing EU banks' sector-wide loan to deposit ratio of 118%).	This implies that if a bank has more loans than deposits there can be no deposits "left over" to fund trading but universal banks do not allocate funding in that way. They deploy funding across the whole group; it is the blended cost of funding for the group that matters. Since retail banking is perceived as safer than trading and can often be funded more cheaply, universal banks obtain artificially cheap funding for their trading activities through their blended group funding. This contributes to resource miss-allocation and higher bank leverage.	Large European G-SIFIs can have widely different loan-to-deposit ratios but very similar levels of TBTF funding advantage, which suggests that funding subsidies and loan-to-deposit ratios are not closely tied.

Nonsense	Sense	Evidence
Large universal banks offer economies of scale and one-stop-shopping, which benefit their customers.	Scale economies only apply for small and medium-sized universal banks. For banks with more than USD 100bn total assets, scale economies do not increase with size.	Research papers suggest that the optimal size of banks could be around $100bn, some papers even suggest that diseconomies of scale and scope might appear above that level (references cited on p17 FW response to HLEG, June 2012, http://www.finance-watch.org/ifile/Publications/Responses/120601-Finance-Watch-response-to-consultation-on-EU-banking-structure.pdf).
	Large size hurts performance relative to smaller banks and brings complexity risk, which can be penalised by the market.	Larger banks do not perform better than smaller banks, whether in terms of RoA, RoE or 5-year market returns (based on HLEG data, page 128 Charts, A3.1, A3.2 and A3.4). The world's 13 biggest investment banks, which represent 54% of the global market, are less efficient and less profitable than the next 200 (McKinsey, Nov 2013, http://www.mckinsey.com/clientservice/Financial_Services/Knowledge_Highlights/Recent_Reports/Return%20of%20Strategy.aspx). Markets can penalise larger banks: e.g. in June 2013 the 46 largest EU banks making up the STOXX Europe 600 Banks Index traded at a price to book ratio of 0.78. The largest banks in this sample, the 16 largest EU G-SIBS, traded at 0.74 in Q2, 2013 (Bloomberg http://www.wallstreetdaily.com/2013/06/13/best-buying-opp-in-30-years, FDIC http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios.pdf)
	From the customer's standpoint: Individuals and SMEs have limited use for investment banking services and where they need them can either interact with more than one bank or buy third party products through their relationship bank. Large corporates already interact with different banks or different entry points in the same bank.	Individuals and SMEs are commonly sold third party insurance and savings products by banks on an agency basis in many EU member states. Rolls-Royce, a large corporate, interacts with around 65 global banking counterparties (http://ec.europa.eu/internal_market/consultations/2012/banking_sector/registered-organisations/rolls-royce_en.pdf).
Structural reform would harm financial stability as it promotes less diversified banking models	The opposite is true: diversification inside firms reduces external diversity in the market and therefore the market's resilience to shocks.	Haldane: "Diversification and diversity might be thought to pull in the same direction. But in finance, they are often engaged in a tug-of-war." http://www.ft.com/cms/s/0/5c7fa72e-3d20-11e0-bbff-00144feabdc0.html#axzz2jCqIKrE5 Haldane: "If all banks are fully diversified and hold the market portfolio, that means they are all, in effect, holding the same portfolio. All are subject to the same systematic risk factors. In other words, the system as a whole lacks diversity. Other things equal, it is then prone to generalised, systemic collapse. Homogeneity breeds fragility." http://www.bankofengland.co.uk/publications/Documents/speeches/2010/speech433.pdf HLEG p.32 : "Diversification at the bank level can make banks more similar to each other and the system as a whole less diversified and vulnerable to shocks" and p. 34: "Over the last decades, financial insitutions – especially the large ones – have become more similar to each other. (…) Overall, the decline in diversity has made the system more intertwined, - and hence more prone to contagion effects."

Cost of corporate funding		
Corporate funding costs would rise if capital market intermediaries, including market makers, lose a funding advantage. This would slow the development of Europe's capital markets and raise funding costs for corporate issuers, thus harming the EU economy.	Common sense suggests the opposite: funding subsidies for large capital market incumbents make it difficult for new participants to enter the market, unless they are also backed by a subsidised entity. Subsidies also reduce the business model diversity of participants, which can harm financial market liquidity. Removing the cross-subsidies in large European universal banks would open the EU's capital markets to new entrants, making them more diverse, competitive and efficient. This should support the EU's goal of helping SMEs to access financial markets, strengthen the Single Market and reduce the cost of funding for corporate issuers of all sizes.	European companies rely more on bank funding than US companies, which have better access to capital markets. "Bank lending in Europe currently accounts for over 80% of corporate financing, while 70% of such financing needs are met by the capital markets in the US" (ISDA/AFME joint submission, link above). The healthy capital markets of the US developed over many years following Glass-Steagall. Lack of competition in the UK equities market: The Institutional Investor Council reports that underwriting fees were 2% prior to 1999 but have been approximately 3.4% since 2007. This is despite the fact that shares were issued at 10–15% below fair value prior to 1999, but have been issued at a 30–40% discount to fair value since 2007 (IIC. Rights Issue Fees Inquiry http://www.iicomm.org/docs/pr141210.pdf, cited in nef 'Quid pro quo'). Concentration in OTC derivatives: 14 of the largest global banks account for 82% of notional outstanding (ISDA, 2010 http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf). In the US, four banks control 93% of all derivatives activity (Office of the Comptroller of the Currency, Q2, 2013 http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq213.pdf)

Nonsense	Sense	Evidence
	There is substantial overcapacity in some areas of market making. In addition, market making for shares and bonds can be refinanced as easily by standalone banks as by universal banks, for example in the repo market.	If banks held 5% of their balance sheet as trading assets this would appear to be sufficient to make markets in the outstanding securities of Government and non-financial firms (explanation in FW 'Europe's Banking Trilemma', p 11 http://www.finance-watch.org/ifile/Publications/Reports/Europes_banking_trilemma_Finance_Watch.pdf). The EU's largest 15 banks hold more than five times this amount, with an average of 27% of total assets held for trading and a similar amount again for derivatives (HLEG A3.2) . In contrast, trading assets at small banks are less than 1% of total assets, and less than 5% at medium-sized banks (ECB 2012, cited in FW response to EC July 2013 http://www.finance-watch.org/ifile/Publications/Responses/130711_Finance_Watch_Answer_EC_Consultation_Banking_Structure.pdf)
	Safer markets lower the cost of capital. Financial centres should benefit in the long-term from market discipline, as market participants would have to improve their risk management and resource allocation across different banking activities. Over time, this would reduce risk in the market as a whole (as opposed to transfering it elsewhere such as investors or taxpayers) which would lower the cost of capital for all participants and reduce the frequency of financial crises.	Countries that paid among the most to bail out their banks in the last financial crises - and that compete for international banking business - have adopted (Switzerland) or are discussing (UK) more cautious prudential regulation on bank sructure and capital than other developed countries.

Cost of hedging risk		
Requiring entities that write or deal in derivatives to bear their full cost of capital would raise hedging costs for real economy end-users, potentially harming the wider economy.	Derivative markets are far larger than is necessary to serve the real economy, having grown nearly six times faster than world GDP since 1995.	OTC derivatives have grown by a factor of 13.4x, from USD 47 trillion in 1995 to USD 632 trillion in 2012 (BIS 1998 p.3 http://www.bis.org/publ/r_fx98finaltxt.pdf). Over the same period, world GDP increased only a sixth as much by 2.4x from USD 30.1 trillion to USD 72.2 trillion (IMF 2013, http://www.imf.org/external/pubs/ft/weo/2013/02/weodata/index.aspx).
	Derivatives have also grown much faster than the financial assets from which they are derived, having grown nearly six times as fast as global equities and bonds (incl government, financial-sector and corporate bonds) since 2000.	From 2000 and 2012, the size of the global equity markets increased 35% from $37 trillion to $50 trillion. Global bond markets increased 138% from $42 trillion to $ 100 trillion. The global underlying notional amount of derivatives increased 531%, from $111 trillion to $700 trillion (data from McKinsey Global Institute report "Financial globalization: Retreat or reset?", March 2013 http://www.mckinsey.com/insights/global_capital_markets/financial_globalization).
	For every derivative that hedges a real economy risk, there are between 10 and 50 times as much traded in purely financial derivatives. This is far in excess of the amount needed to "lay off" the risks of real economy hedging among other financial counterparties.	More than 90% of derivatives are between purely financial entities and have no real economy counterparty: globally, only 7% of OTC derivatives involve a non-financial counterparty (BIS 2012, http://www.bis.org/statistics/dt1920a.pdf); in the US, 92% of derivatives are designated as for trading and only 2% for end-users (OCC. Q2, 2013, graph 1 http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq213.pdf). The total global notional outstanding value of OTC and exchange traded derivatives is now around $700 trillion, or 10x global GDP (BIS). It has expanded sevenfold since 2000, a period that includes two major financial crashes. Today's derivatives market is equivalent to $100,000 for every man, woman and child alive (http://www.census.gov/population/popclockworld.html).
	A reduction in derivatives capacity would reduce systemic risk.	G-SIFIs with high levels of derivatives activity are more vulnerability to default: an OECD study of data from 94 US and European banks 2004-2011 found the gross market value of G-SIFI derivatives as a proportion of total assets was a key driver in their distance to default (the number of standard deviations away from the default point) and was statistically significant at the 1% level (p. 14, Financial Market Trends No 103, 'Business models of banks, leverage and the distance-to-default' Jan 2013 http://www.oecd.org/finance/BanksBusinessModels.pdf)
	The cost of hedging risk via derivatives for most non-financial firms is small relative to their other costs and even smaller relative to total output, while the total output losses from financial crises are very large.	The median net present value cost of financial crises is 63% of annual GDP (survey by BCBS, 2010 http://www.bis.org/publ/bcbs173.pdf). If crises occur every 20-25 years, that is is equivalent to losing about 3% of GDP a year in perpetuity (ICB 5.8, http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf).