Finance Watch

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FINANCE WATCH POLICY BRIEF

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Separating universal banks from too-big-to-fail banks (TBTF)

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Europe's largest banks

- are very few in number – around 20 banks
- are disproportionately involved in financial markets
- overwhelmingly face other financial institutions in financial markets
- dominate financial market liquidity and infrastructure provision

Europe's middle sized banks

- are Europe's real universal banks
- lend proportionately more than large banks
- undertake limited financial market activity for clients
- serve local economies
- are generally untouched by bank separation proposals

As a result they:

- ➔ are too-big and...
- ➔ …too-interconnected to fail, even with Bank Recovery and Resolution (BRRD)
- ➔ are too-complex to manage, regulate and resolve
- ➔ pose an unjustified danger to deposits and payment systems
- ➔ receive a moral hazard subsidy
- ➔ distort competition and prevent free and fair markets
- ➔ should have their trading operations ring-fenced from their commercial banking operations
- ➔ are so large that even a modest loss could cause devastating damage to the economy – with bail-in the pensions and insurance premiums of normal people will be lost, with bail-out they will pay through taxes and austerity
- ➔ In short, they pose a serious systemic risk: they are more exposed than mid-sized, universal banks to failure whether alone or, more importantly, at the same time as other TBTF banks

In this report we examine a range of evidence that illustrates the anatomy of European banking

EU medium sized banks are its true universal banks NOT the very large trading banks

Europe's banks can be usefully split into small, medium and large banks.[1] The three size groups display very different characteristics as we will examine below.

Table 1: estimated number of banks small/medium/large[2]

		Large	Medium	Small	Total
2013	**Number**	19	413	2081	2513
	Avg Total Assets (billions Euros)	886	13	0.056	
2008	**Number**	32	459	2251	2742
	Mortality rate	*41%*	*10 %*	*8%*	*8%*

IFRS Reporters

The comparatively bigger decline in the number of large banks led to a further concentration in large banks.
Source: ECB Consolidated Banking Data and own calculations

Study of the financial accounts of these groups of banks show:

Medium sized banks are universal banks, they undertake proportionately more lending than large banks (and proportionally less trading) but more trading than the smallest banks. Their average size is EUR 12.7bn. They are responsible for a larger share of the Eurozone's bank loans (29%) than might be warranted by their share of total assets (26%) and dedicate proportionately more of their balance sheets to loans (66%) than larger banks (52%).

A recent BIS paper found banks could be split into retail funded commercial banks, wholesale funded commercial banks and capital market banks. It found that retail funded commercial banks – the best characterisation of Europe's medium-sized banks – had better and more stable profitability.[3]

Such banks tend to emphasise relationships, which can "increase the availability of credit in some cases and reduce interest rates on loans".[4]

These banks represent the traditional European universal bank business model.[5]

Large banks are traders that dedicate more of their balance sheet to trading assets, lend proportionally less to the economy and hoard proportionately more at central banks. They are *very, very large* with average total assets of over EUR 886bn. While they hold 76% of EU banks' total assets they have a disproportionately large share of trading assets (93%) and of assets parked at central banks (86%). **Only half their balance sheets are dedicated to loans, compared to two-thirds for medium sized or universal banks.**

A recent study found that the largest and most international banks are 'investment-oriented' (i.e. trading). "The banks are among the most leveraged (i.e. low proportion of tangible common equity to total assets) and engage extensively in trading activities while relying on debt securities and derivatives for funding. Yet the average trading income [relative to trading assets] is below that of diversified retail banks that have substantially less trading activities, but a more stable

1 As they are by the ECB's consolidated bank balance sheet reporting.

2 Note that the number of consolidated entities per size group is not given directly in the ECB consolidated bank data – however an estimate can be calculated through data which gives a count of entities per ROE band. Note further that non-IFRS banks, almost all of which are small, are excluded from this table.

3 BIS, 2014.

4 Elyasiani and Goldberg, 2004.

5 Note that there have been some high-profile failures of mid-sized banks since 2007. We would note two things: first, the failure of these banks did not pose a systemic risk, they were NOT too-big-to-fail, were allowed to fail and did not require bail-out; second, as we note in our Position paper on long term financing, securitisation and securities financing: "Banks like Northern Rock and some Spanish cajas that experienced difficulties during the crisis were not pure traditional banks as they relied on wholesale funding and some were involved in securitisation." Finance Watch, 2014.

trading income."[6] In short, the largest banks on average have a lower and more volatile trading income relative to trading assets (although in good years they may take home more) and this is linked to their higher leverage, or riskier balance sheet structure.

As we will see they dominate financial markets in several ways.

Small banks are numerous but their total assets are very small, their average total assets are a mere EUR 57.6 million. They are not included in the table below but can be seen in the appendix.

Table 2: Shares of total per line item across all banks in the sample

IFRS Reporters

Billions of Euro	**All**	*Selected Assets* **Large**	**Medium**
Loans and receivables including finance leases	12,252	71%	29%
Held for Trading*	3,240	93%	7%
Balances with central banks	759	82%	18%
Other Balance Sheet items	4,177	69%	32%
Total Assets	22,166	76%	24%
Average Total Assets		**886**	**12**

** The same proportions hold for "Held for trading - derivatives" which account for 1,735bn of "Held for trading".*

Table 2b: Share of total assets for each size grouping

IFRS Reporters

Billions of Euro	*Share of Total Assets per size grouping* **Large**	**Medium**
Loans and receivables including finance leases	52%	66%
Held for Trading	18%	4%
Balances with central banks	4%	3%

For fuller tables please see Appendix 1. Source: Consolidated Banking Data, ECB, 2014 and own calculations.

European too-big-to-fail banks are very different from the average EU universal bank

These very large banks are not just bigger but really are different: different from other banks and **different from our usual idea of universal banks.**

In the wake of the financial crisis the Financial Stability Board (FSB) developed a methodology for recognising too-big-to-fail banks (labelled 'Global Systemically Important Financial Institutions' (G-SIFIs)). They used a methodology which recognised size, complexity, substitutability, interconnectedness and global activity.[7] This approach was reinforced in Europe in 2014 when the EBA published a similar methodology.

Amongst G-SIFIs the FSB now distinguishes 'Global Systemically Important Banks' (G-SIBs). Based upon the latest data (Nov 2014) there are 14 EU and 2 Swiss G-SIBs[8] as well as 2 EU based ex-G-SIBs[9] – on this measure all together 18 banking groups that could pose a threat to the stability of our financial, economic and social system.

6 CEPS, 2014.

7 BBVA Research, 2014.

8 BBVA; BNP Paribas; Deutsche Bank; Group Crédit Agricole; Group BPCE; ING Bank; Nordea; Santander; Société Générale; Unicredit Group; Credit Suisse; UBS; Barclays; HSBC; Royal Bank of Scotland; Standard Chartered. FSB, 2014.

9 Commerzbank; Lloyds Banking Group. FSB, 2014.

Large trading banks are clearly separate from the rest – European Commission threshold analysis

More evidence of the disproportionate financial market activity of the largest banks compared to traditional universal banks (i.e. Europe's mid-sized banks) comes from the European Commission.

They investigated the thresholds at which trading banks could be separated from other banks. They found that a fairly consistent group of banks emerged "with either a significant volume of trading activities [above a monetary threshold] or with a significant share of trading activities [above a % threshold]".[10] Moving thresholds, within a sensible range, did not make a great deal of difference to the selected banks, for example moving the volume threshold from EUR 100bn to EUR 80bn did not change the selected set of banks. **In other words there is a distinct difference or "clear water" between TBTF and other banks.**

In line with the evidence above they also found that the selected group of trading banks is small but accounts for a large share of total assets – for example any given measure gave 30-36 banks accounting for 50-75% of total assets. Importantly 20 banks met the criteria as trading banks under all 4 definitions that the Commission used, and these banks accounted for around 50% of total assets.

Big trading banks dominate financial markets

Large banks dominate financial markets, both in providing liquidity and in providing the infrastructure of the markets; in doing so they stifle free and fair competition.

Liquidity:

To judge the size and basic characteristics of OTC derivative markets the BIS polls around 250 dealers to survey the whole markets. These dealers form one side of every OTC derivative – OTC derivatives are a banking product as deposits are. But actually these markets are much more concentrated with only 20 global banks dominating.

- In 2010 ISDA estimated that >80% of derivatives outstanding were provided by the 14 largest firms.[11]

The Euromoney survey looks at client facing activity (i.e. not interbank activity) and in 2014 it found:

- the top 15 banks had a total market share of 88% in the foreign exchange market
- the top 10 banks had a total market share of 80% in the foreign exchange swap market

The rates survey has been discontinued but in 2012 it found:

- the top 15 banks had a total market share of 94% in interest rate markets
- the top 10 banks had a total market share of 84% in the cross-currency basis swap market

Infrastructure and regulation:

This market weight gives these firms a very large say in the provision of banking and finance infrastructure. This arises mainly for three reasons:

- much infrastructure is provided by the largest firms themselves
- they have a large representation on infrastructure provided by others (e.g. exchanges)
- they spend more than others on lobbying

10 European Commission, 2013.

11 ISDA, 2010.

Example: In the UK the largest banks dominate the payment systems which is stifling competition from "challenger banks".[12]

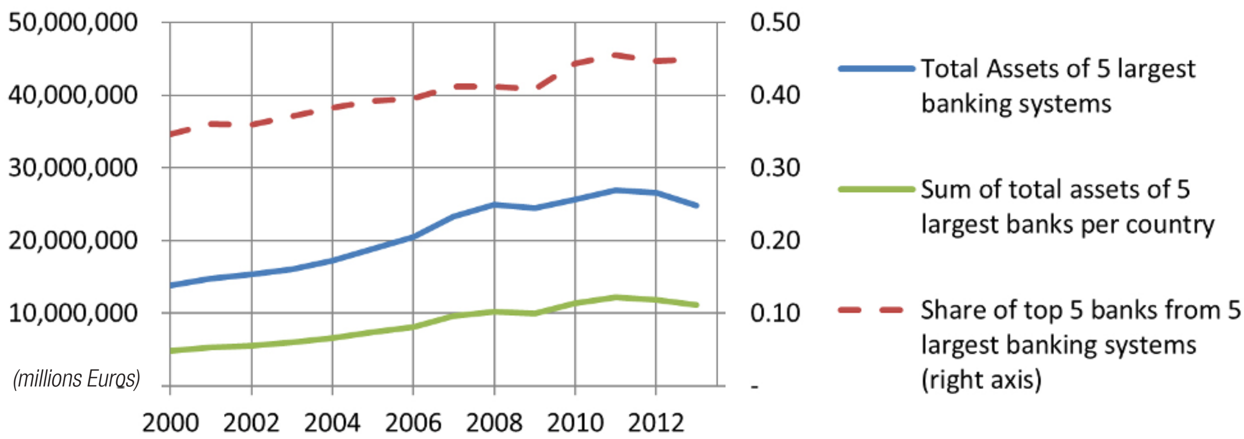
Example: The seats / boards of exchanges and professional organisations such as ISDA are overwhelmingly made up of staff / ex-staff from the largest banks.[13]

Example: The largest banks "not only profit from their high turnover and financial wherewithal to lobby in Brussels and elsewhere, but also from links to other associations that will then try to influence the EU legislation." The result is very often "an echo-chamber leading to multiple representations of organisations in specific consultations or groups (e.g. if there are consultation responses by Deutsche Bank, but also the European Banking Federation, European Fund and Asset Management Association, German Banking Federation, International Swaps and Derivatives Association, these are all associations where Deutsche Bank is represented)."[14]

TBTF banks are growing more concentrated

The largest banks are increasing their share of the market, and so becoming even more dominant.

Banking is becoming more concentrated, both before and after the crisis, as the ECB's own Banking Structure Report shows[15]. In the graph below we show the share of the five largest banks of the five largest economies in the Eurozone.[16] The share of the five largest banks has risen since the outbreak of the financial crisis in 2008 – partly because the largest banks can afford to buy up crisis-hit small banks which are deemed not too-big-to-fail.



Source: ECB, 2014

Too much finance by finance for finance

There are two clear further results of allowing subsidised too-big-to-fail banks to grow and dominate in this way.

First, banks have grown out of all proportion to the economy – as we have seen as the largest banks make up 75% of all total assets it is really the largest banks that have grown out of proportion to the economy. The graph below shows total banking assets and annualised GDP of the Eurozone.

12 Financial Times, 2015 and Financial Times, 2014.

13 Lindo, 2013.

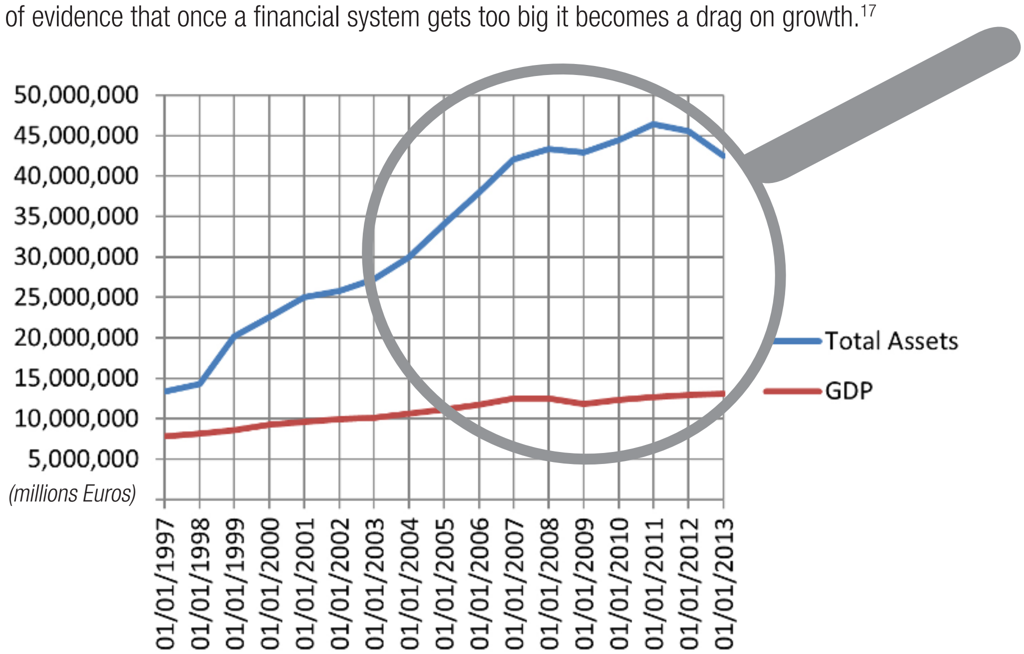
14 CEO, 2014.

15 ECB, 2014.

16 France, Germany, Spain, Italy, Netherlands – source ECB - Statistical Data Warehouse

- Even a small loss suffered on banking assets of this scale will need to be absorbed by the rest of the economy and would be disastrous. Don't forget the holders of bank debt and equity are likely to be either other banks or those firms that are investing our pensions and our insurance premiums. Losses will be passed to our savings if we bail-in the largest banks or to our taxes if we bail them out.
- There is plenty of evidence that once a financial system gets too big it becomes a drag on growth.[17]

Total banking assets and annualised GDP of the Eurozone (Source: ECB Aggregated Balance Sheet Data)



Second, financial markets have become overwhelmingly about finance by finance for finance. Only a tiny proportion of financial market activity is undertaken by financial firms and even then it is often non-financial firms being dragged into financial market activity.

- Less than 10% of derivatives notional outstanding faces non-financial firms
- World trade equals less than 2% of currency trading[18]
- Less than 10% of securities issued are issued by non-financial firms

In short

The overall picture is that Europe's mid-sized banks are its true universal banks, lending to local markets and providing access to money and capital markets for productive firms and servicing SMEs.

Financial markets however have become dominated by a small group of very, very large banks, swollen by TBTF subsidies. These banks:

- dominate and distort free and fair markets in money and capital.
- trade mostly in financial products with other financial firms, increasing the fragility of the financial system.
- are so large that even a modest loss would cause devastating damage to the economy – bailed-in the pensions and insurance premiums of normal people will be lost, bailed-out they will pay through taxes and austerity.
- are so complex that it is doubtful a bank failure could be resolved before wide-spread panic took hold
- are more likely to experience difficulties at the same time and thus contribute more to systemic risk

17 Stiglitz, 2000; IMF, 2012; BIS, 2012; BIS, 2015.

18 World Bank Data, 2015. BIS, 2013.

What to do?

If Europe wants its true universal banks to flourish it needs to take further steps to tackle its TBTF banks. Separation would be an important next step.

If Europe wants its Capital Markets Union to work it needs to level the playing field, remove the TBTF subsidy and move towards a capital market of many, reasonably sized and diverse institutions using a common infrastructure such as tightly regulated exchanges, central counterparties and payment systems (CCPs) equally accessible to market participants and less exposed to systemic risk. Without action the forthcoming Capital Markets Union will be a union of the too big to fail.

Further reading

Finance Watch: "**Europe's Banking Trilemma – Why banking reform is essential for a successful Banking Union**", September 2013
[online available at: http://www.finance-watch.org/our-work/publications/687-europe-banking-trilemma]

Finance Watch: "**Structural reform to refocus banks on the real economy**", August 2014
[online available at: http://www.finance-watch.org/our-work/publications/898-fw-policy-brief-august-2014]

Finance Watch: **Separating facts and fiction – A Finance Watch report looking at some of the confusing and contradictory arguments made against regulating the structure of the largest, too-big-to-fail, too-complex-to-fail-manage-and-regulate, too-connected-to-fail banks.** *Upcoming*

Appendix

Source: Consolidated Banking Data, ECB, 2014 and own calculations.

IFRS Reporters, 2013

(Thousands EUR)	**All**		**Large**		**Medium**		**Small**	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Balances with central banks	759,987,521	486,593,311	620,237,919	224,709,479	136,038,440	258,830,095	3,711,162	3,053,737
Loans and receivables including finance leases	12,252,504,746		8,693,081,754		3,494,158,286		65,264,706	
Financial liabilities measured at amortised cost		14,143,323,401		10,281,520,971		3,784,567,682		77,234,748
Financial liabilities associated with trans-ferred financial assets		264,714,765		190,811,046		72,311,023		1,592,696
Available-for-sale financial assets	1,710,455,272		1,186,797,696		506,805,544		16,852,032	
Held for Trading	3,240,609,894	2,592,992,525	3,025,886,547	2,418,588,195	211,862,455	173,093,244	2,860,892	1,311,086
of which held for trading derivatives	*1,735,506,551*	*1,705,047,810*	*1,618,397,006*	*1,584,249,714*	*116,404,857*	*120,020,768*	*704,688*	*777,328*
Designated at fair value through profit or loss	578,449,677	715,135,275	470,215,073	504,040,596	107,854,365	210,389,385	380,239	705,294
Held-to-maturity investments	326,699,875		142,487,368		179,127,517		5,084,990	
Derivatives-Hedge accounting	183,005,134	228,907,737	127,107,735	150,170,580	55,741,818	78,617,011	155,581	120,146
Investments in associates	143,680,652		106,189,574		36,088,211		1,402,868	
Tangible, Intangible and Other (not given)	1,235,424,894	1,587,239,374	855,466,832	1,154,200,989	431,863,272	447,968,590	23,620,890	30,137,155
Assets and Liabilities	22,166,324,216	21,723,954,198	16,845,867,504	16,508,291,570	5,275,944,765	5,145,797,798	120,038,048	114,932,190
Provisions		202,009,964		169,675,257		31,822,820		511,887
Issued capital		240,360,054		133,753,385		101,940,058		4,666,611
Capital, Provisions and group invest-ments	-	442,370,018	-	303,428,642	-	133,762,878	-	5,178,498
Total Assets	22,166,324,216	22,166,324,216	16,845,867,504	16,811,720,212	5,275,944,765	5,279,560,676	120,038,048	120,110,688
Leverage (calculated as own funds over total assets)	1.9%		1.8%		2.54%		4.31%	
Non-IFRS Reporters - Total Assets	2,695,381,080		-		1,833,339,451		862,041,629	

IFRS Reporters, 2013

(Thousands EUR/ % of All IFRS Reporters)	**All**		**Large**		**Medium**		**Small**	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Balances with central banks	759,987,521	486,593,311	82%	46%	18%	53%	0%	1%
Loans and receivables including finance leases	12,252,504,746		71%		29%		1%	
Financial liabilities measured at amortised cost		14,143,323,401		73%		27%		1%
Financial liabilities associated with transferred financial assets		264,714,765		72%		27%		1%
Available-for-sale financial assets	1,710,455,272		69%		30%		1%	
Held for Trading	3,240,609,894	2,592,992,525	93%	93%	7%	7%	0%	0%
of which held for trading derivatives	*1,735,506,551*	*1,705,047,810*	*93%*	*93%*	*7%*	*7%*	*0%*	*0%*
Designated at fair value through profit or loss	578,449,677	715,135,275	81%	70%	19%	29%	0%	0%
Held-to-maturity investments	326,699,875		44%		55%		2%	
Derivatives-Hedge accounting	183,005,134	228,907,737	69%	66%	30%	34%	0%	0%
Investments in associates	143,680,652		74%		25%		1%	
Tangible, Intangible and Other (not given)	1,235,424,894	1,587,239,374	69%	73%	35%	28%	2%	2%
Assets and Liabilities	22,166,324,216	21,723,954,198	76%	76%	24%	24%	1%	1%
Provisions		202,009,964		84%		16%		0%
Issued capital		240,360,054		56%		42%		2%
Capital, Provisions and group investments	-	442,370,018		69%		30%		1%
Total Assets	22,166,324,216	22,166,324,216	76.0%	75.8%	23.8%	23.8%	0.5%	0.5%

Source: Consolidated Banking Data, ECB, 2014 and own calculations

IFRS Reporters, 2013

% of Total Assets	**All**		**Large**		**Medium**		**Small**	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Balances with central banks	3%	2%	4%	1%	3%	5%	3%	3%
Loans and receivables including finance leases	55%		52%		66%		54%	
Financial liabilities measured at amortised cost		64%		61%		72%		64%
Financial liabilities associated with transferred financial assets		1%		1%		1%		1%
Available-for-sale financial assets	8%		7%		10%		14%	
Held for Trading	15%	12%	18%	14%	4%	3%	2%	1%
of which held for trading derivatives	*8%*	*8%*	*10%*	*9%*	*2%*	*2%*	*1%*	*1%*
Designated at fair value through profit or loss	3%	3%	3%	3%	2%	4%	0%	1%
Held-to-maturity investments	1%		1%		3%		4%	
Derivatives-Hedge accounting	1%	1%	1%	1%	1%	1%	0%	0%
Investments in associates	1%		1%		1%		1%	
Tangible, Intangible and Other (not given)	6%	7%	5%	7%	8%	8%	20%	25%
Assets and Liabilities	100%	98%	100%	98%	100%	97%	100%	96%
Provisions		1%		1%		1%		0%
Issued capital		1%		1%		2%		4%
Capital, Provisions and group investments		2%		2%		3%		4%
Total Assets/Liabilities	100%	100%	100%	100%	100%	100%	100%	100%

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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