Finance Watch

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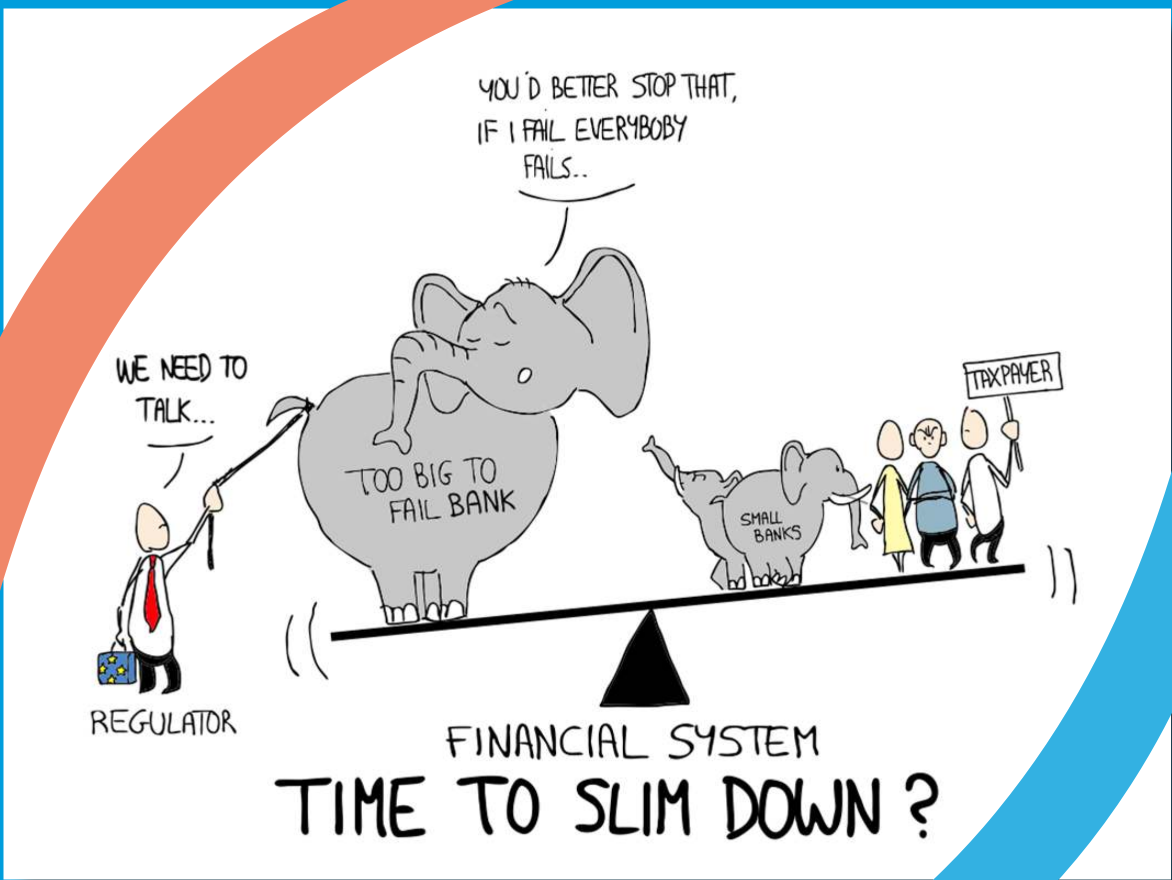
Separating fact and fiction...

A Finance Watch note looking at some of the confusing and contradictory arguments made against regulating the structure of the largest, too-big-to-fail, too-complex-to-manage-and-regulate and too-connected-to-fail banks.



CLAIM: We have done enough to protect the financial system

CLAIM: Higher Capital Requirements are enough.

No, because:

1. The biggest banks need very little capital in good times but can never have enough capital in a system wide stress (the so-called **regulators' paradox**), where their trading business (especially derivatives trading) and leverage make them highly vulnerable.

2. The large trading portfolios on the asset side of large banks' balance sheets are funded in large part by wholesale funding. This makes them very vulnerable in times of stress: in good times the conditions to obtain funding are relaxed (low haircuts, wide range of assets accepted as collateral), especially for banks with a too-big-to-fail (TBTF) status. When however market conditions worsen, banks are hit on both sides of the balance sheet: a drop in asset prices can lead to losses on investments that can wipe out the bank's capital. At the same time this drop can also make it impossible to meet margin calls and higher haircuts on collateral, resulting in funding stress.

   The Liquidity coverage ratio (LCR) and Net stable funding ratio (NSFR) are not addressing these problems either – they mostly aim at reducing maturity mismatches between assets and liabilities at an institution level. Even if banks' books of securities financing transactions are perfectly matched, a reduction in their access to funding can force them to engage in asset fire sales or to abruptly withdraw credit from customers. [Tarullo, 2013 and Finance Watch, 2014]

3. As an illustration, a 2013 OECD study showed that in 2009 the 69 largest US and European banks, which had $1.6 trillion in combined capital, would have required an additional $4.5 trillion – almost a quadrupling! – to remain at a safe level during the crisis.

   Hence no reasonable ex-ante amount of capital will protect the biggest trading-oriented banks from failing if their structure is not changed. [OECD, 2013]

4. **The capital requirements framework is mostly micro-prudential**: it focuses on the risk of individual institutions failing and not on the system. It does not integrate the correlation between banks' balance sheets (as large global banks hold similar portfolios of assets), their interconnectedness through webs of contracts, nor the risk of losses conditional on the losses of other institutions, all of which are needed to assess the risk of joint bank default. As long as the prudential framework for banks does not integrate more macro-prudential elements, we will not have reduced the risk of future systemic crises.

CLAIM: We have done enough to protect the financial system

CLAIM: Recent and forthcoming crisis management tools such as the Bank Recovery and Resolution Directive (BRRD) / Total Loss-Absorbing Capacity (TLAC) / and the Single Resolution Mechanism (SRM) are enough.

No, because:

1. Taken alone **the steps to increase resolution powers are not enough**. TBTF banks remain too-large, too-complex and too-interconnected to resolve over a weekend. As an example the recovery and resolution plans of some of the largest banks are 1800 pages long. It took years to unwind Lehman Brothers' derivatives business [Bloomberg, 2013]. Even the European Banking Authority does not believe that without clear ex-ante legal separation the resolution authority will be in a position to apply resolution tools that change the business models of the biggest banks [EBA, 2012].

2. The TBTF banks are so large and leveraged that even a limited loss in percentage of their balance sheets such as 3% of total assets could cause devastating damage to the economy through a bail-in or a bail-out.

3. **Moving losses around does not make them disappear**: with bail-in the pensions and health insurance premiums of citizens will be adversely affected, with bail-out citizens will pay through higher taxes and austerity.

4. TLAC is based on the assumption that banking groups are structured in a way which clearly identifies core banking functions and allows the appropriate distribution of loss absorbency instruments. However without structural measures this assumption will not hold [Finance Watch, 2015].

5. In theory, the existence of bail-in-able debt should increase market discipline. It is however likely that it will first incentivise global systemically important banks (G-SIBs) to take on more risks as long as market confidence is there. Secondly, when the first G-SIB instruments are bailed-in and market confidence in them disappears, the effectiveness of TLAC/bail-in-able instruments is likely to evaporate. **In other words the bail-in of systemic banks will work only once** [Finance Watch, 2015].

CLAIM: We have done enough to protect the financial system

CLAIM: Central clearing and the new infrastructure are enough.

No, because:

1. **Only the least risky parts of the derivatives market can be subject to central clearing**, i.e. only large standardised and liquid swaps [OECD, 2013]. Moreover, central counterparties (CCPs) do not make the credit risk or market risk disappear and their ability to mitigate it will depend on their risk management framework and appropriate capital levels.
2. CCPs are also highly interconnected with market participants and financial markets and their default may cause unexpected credit losses and liquidity shortages. **This makes CCPs too important to fail themselves** [IMF, 2015].
3. In addition the biggest banks also remain too interconnected because of their reliance on wholesale funding (amounting to 61% of total liabilities in Europe – IMF, 2012) which creates collateral chains and fragile funding structures. The exemption from bail-in of repo and other types of collateralised funding in BRRD further encourages this.

CLAIM: Supervision, stress tests and the Single Supervisory Mechanism are enough.

No, because:

The **regulators paradox** (namely the fact that banks can never have enough capital in bad times) **was not accounted for during the stress tests of the European Central Bank**, since the tests were based on Risk Weighted Assets and the Single Supervisor did not verify the reliability of the internal models that banks used to calculate stressed Risk Weighted Assets. The stress tests were also focused on the risk of individual institutions, whereas second round effects for individual banks and the banking system as a whole were not taken into account.

CLAIM: National laws are enough.

No, because:

The **single supervisor needs a single set of rules to be effective** and to ensure a regulatory level playing field - this is the whole concept behind the single rulebook. However in reality inconsistent national legislations are likely to limit the effectiveness of the Single Supervisory Mechanism and to increase supervisory costs and complexity [ECB, 2014].

CLAIM: Splitting banks would break the system

CLAIM: Small and medium sized banks are the real problem.

SUB-CLAIM: Splitting banks would reduce the diversification of income.

SUB-CLAIM: Retail banks are more fragile due to their undiversified income stream.

No, because:

1. While some small retail banks failed during the crisis, it is because **they were NOT too-big-to-fail** that they were allowed to fail. This is precisely why they should be encouraged: because they can fail safely without posing a systemic risk. Symmetrically mega banks did not avoid failure because they were universal and more resilient but because they were considered too-big-to-fail and therefore bailed out.

   The argument that the largest banks are universal, universal banks are more resilient because they are more diversified therefore the largest banks are more resilient is also a syllogism.

   In addition it must be noted that the retail banks that experienced difficulties, such as some Spanish cajas and Northern Rock, were not pure traditional banks because they relied on wholesale funding and some were involved in securitisation [Finance Watch, 2014].

2. While mortgage-based financial instruments were a major factor in the crisis, **traditional mortgage lending itself was not responsible**. Rather it was the ability to repackage and improve the rating of bad assets through tranched securitisation that enabled and fuelled the boom in subprime loans, driven by the largest trading banks. This encouraged irresponsible lending, the banks took the profits, got bailed out and remain subsidised to do it again thanks to their (continuing) TBTF status.

3. In addition, the argument that a separation would create new forms of banks which pose problems **directly contradicts the argument that BRRD is enough to resolve any bank in trouble**.

4. The argument that retail funded traditional banks are more fragile due to a less diversified stream of income contradicts the evidence from the crisis where retail funded traditional banks proved more resilient than other business models [BIS 2014].

CLAIM: Splitting banks would break the system

CLAIM: You need mega banks to run the financial system because that is the current market structure.

SUB-CLAIM: Splitting banks would kill the market makers. Who would then provide the liquidity and the infrastructure?

CLAIM: If you want a Capital Markets Union you need mega banks.

No, because:

1. The new market infrastructure of exchanges and CCPs will move away from the current oligopolistic financial market infrastructure provision by G-SIBs.
2. A Capital Markets Union run by the G-SIBs for the G-SIBs cannot achieve the efficient market benefits it claims. **It will be a union of TBTF banks.**
3. Markets are better served if **liquidity comes from many diverse market players**.
4. Shareholders should be able to choose for themselves a diverse portfolio of many varied banks. Currently they must choose between a small number of mega banks who display a herding behaviour in both trading strategies and organisational structure. Such an oligopolistic structure is not diverse and not resilient as the correlation between the largest banks' balance sheets increases the risk of joint defaults.
5. As noted by Mark Carney [FSB, 2015] **market funding is inherently fragile because liquidity can evaporate faster in times of crisis compared to 'boring bank' finance**. Encouraging ever more market funding increases this fragility.
6. Linked to the previous point, increasing liquidity is not always desirable as liquidity is inherently procyclical and withdraws very quickly in times of stress. It also contradicts the objective of the long term financing agenda to promote patient capital to finance long term assets, for which you do not need that much liquidity. Banks and investors need to rediscover their job of assessing creditworthiness and then provide stable, unsecured lending to assets that are not always liquid, instead of relying on the false assumption that they can sell assets very quickly [Finance Watch, 2014].

We claim...

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Banks structural reform will bring positive change unless it is merely a cosmetic regulation, in which case it would be better to do nothing than give an illusion of reform.

In 200 words, this is true because:

1. Banks' core functions must be protected.
2. But investment banks should be allowed to fail. This will only be possible if:
   - the core (critical) banking functions are identified and insulated from riskier and less essential activities;
   - banks are of a size which allows them to pass through the BRRD mechanisms;
   - and they are simple enough for BRRD mechanisms to work.
3. The largest TBTF banks are not Europe's universal banks [Finance Watch, 2105a]. In essence, **they are trading banks with volatile income streams** [BIS, 2014] that crashed the economy once and are in a position to do so again. It is worth noting that the weakening of the Swiss franc at the beginning of 2015 resulted in large trading-desk losses for market-making banks: three banks alone lost USD 300 million (Deutsche Bank, Barclays and Citi [Economist, 2015]).
4. The reform **will not apply to medium-sized and small banks, Europe's true universal banks**. It only aims to tackle TBTF.
5. If we want to promote capital markets we need diverse market players, competition and a fair pricing of risks, otherwise the **Capital Markets Union will be a union of TBTF banks**.

Here is the form it should take:

1. The Commission's proposal **should be strengthened**, not weakened.
2. **Clear ex-ante rules** and **minimum supervisory discretion** are key to an effective reform.
3. Structuring banking groups as **a non-operating-holding-company** with two separate subgroups (a core banking group and a trading group) would enhance resolution by insulating core banking functions. It will still enable diversified sources of income and synergies at the consolidated group level.
4. **The ring-fence should be high enough**. Hence the need for an appropriate group structure and regulation of intra and extra group exposures and a ban on down-streaming of capital from the parent to the trading sub-group.
5. Market-making inherently involves holding an inventory of trading assets. The supervisors will find it extremely difficult – if not impossible in practice – to differentiate between proprietary trading and market making. **Consequently market making should be separated.**

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ABBREVIATIONS

BRRD	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC,2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations(EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council
CCPs	Central Counterparties
EBA	European Banking Authority
G-SIB	Global Systemically Important Bank
LCR	Liquidity Coverage Ratio
NSFR	Net Stable Funding Ratio
RWA	Risk Weighted Assets
SRM	Single Resolution Mechanism
TBTF	Too-Big-Too-Fail
TLAC	Total Loss-Absorbing Capacity

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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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