Splitting Megabanks?

Understanding Finance #1

Finance Watch
Making finance serve society

Part of the Finance Watch Campaign Change Finance!

SLIM DOWN MEGABANKS
PUT SOCIETY IN THE DRIVING SEAT
STOP SUBSIDIZING SPECULATION
INCENTIVIZE SUSTAINABLE INVESTING
"The case for a strong structural reform is beyond doubt. It must now be matched by political will. There is no public interest reason for citizens and taxpayers to continue supporting too-big-to-fail banks."

Thierry Philipponnat, Secretary General of Finance Watch
Splitting Megabanks?

The European Commission’s legislative proposal on bank structure reform released in January 2014 has been long awaited. Five years after the most severe financial crisis in 80 years hit the global economy, analysts from all sides agree that the European banking system remains dominated by a handful of too-big-to-fail universal banks so huge that their failure would threaten whole economies.

This multimedia dossier gives you a non-technical overview on the issue of bank separation and explains Finance Watch’s position on this crucial issue. Beyond the jargon, the core question is actually a simple one: should megabanks be split?

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What is a universal bank?

Universal banks combine both commercial banking activities and investment banking activities under the same roof.

In the last four decades, the banking landscape has changed a lot as a result of waves of liberalisation and deregulation. As a result, some universal banks have grown enormously in size, becoming the megabanks that dominate Europe’s banking sector today.

- **Commercial banking activities** are the services that your local bank provides you on a daily basis, such as giving you loans, looking after your money and running the systems you use to pay for goods and services.
- **Investment banking activities**, on the other hand, include trading (buying and selling) financial assets such as securities and derivatives. These services can be useful for companies wanting to raise money to invest, or manage their risk.

The problem is that much of the trading that goes on in megabanks today involves only financial firms. Citizens and most small and medium companies hardly use these services, while bigger companies ("non-financial corporates" in the language of financiers) need only a fraction of the trading carried out by megabanks: less than 10% of debt securities issued, less than 10% of OTC derivatives and less than 5% of foreign exchange trading is used by companies in the real economy.

Essentially, a universal bank combines activities that are fundamentally different in nature: your commercial bank typically involves long-term lending relations, whereas trading by investment banking typically involves a short-term perspective. Today, with universal banks combining commercial and trading activities, the culture of short-term, deal-based, investment banking can influence the long-term, relationship-based culture of commercial banking.

> Watch our short video “What are universal banks and what is the problem?”
Why are large universal banks a problem?

First of all, large universal banks cannot fail! Because they manage everyday services such as deposits, lending and payment systems, these services cannot be interrupted for a single day.

Imagine for instance that you could not withdraw your money from the cash-machine or that you could not pay at a shop? That would be a serious problem for any complex contemporary economic system. For that reason, governments are obliged to intervene to save commercial banks when other routes have failed. Universal banks will therefore be rescued by government even if only their financial trading activities fail.

Secondly, they develop risky trading activities.

And there is another consequence: these banks benefit from “subsidised funding” thanks to the state-backing of their retail banking arms. This means that, because the state guarantees that these financial firms cannot go bust, it is cheaper for them to borrow money than for other banks or financial firms. And as banks borrow a lot of money to operate, this is a huge advantage that disturbs competition within the banking sector.

And on top of this, what do you think those big banks do with this “cheap money”? They develop highly leveraged* (see Mr Jargon below) and risky trading activities while being assured of public support in case of a major loss. Speculation on the derivatives markets (for example with food commodity futures) is a highly profitable and risky activity.

Thirdly, this means that citizens have to pay for bank failures. The way these megabanks are structured makes them too big, too important, too complex, and too interconnected to fail. In response to the crisis in 2008, avoiding a collapse of the banking system came at a huge cost for tax payers! In total, European nations have spent no less than EUR 400 billion in state aid and that amount goes to EUR 1,600 billion if you include guarantees and emergency liquidity provided by states to banks. This is 12% of the whole EU GDP, or in other words 12% of the entire value of all goods and services produced in 2012 in the EU... Moreover, this huge amount does not include all the side-effects of the financial crisis on both the economy and society. This includes a long recession and the social harm caused by high (youth) unemployment. Reforming the structure of the banks is therefore a necessary condition to protect European citizens from paying again for bank failures.
Mr Jargon answers your question

You might have often read the word “Leverage”. Well, this is a crucial idea to understand in the world of finance!

Actually it is very simple as it refers to how much money you’ve borrowed compared with the capital you have on hand. Let’s say you want to buy a house and you already have 20% of the purchase price in cash. So for every euro you’ve got in capital, you’ve got to borrow four. Your leverage is 4 to 1.

Imagine now that you are a bank, and that you earn money by lending money (=buying financial assets). This leverage effect becomes very interesting because it enables you to make more profit for your shareholders (the owners of the banks) in good times: the more leveraged you are, the more you can lend (not using your own money but money you borrowed).

The downside of this clever mechanism is that it makes banks fragile. Before the crisis in 2007, it was common for universal banks to reach a leverage of 30 to 1 or even more! A bank with capital of 1 could buy assets on the financial markets worth at least 30 times more (thanks to money borrowed). Here comes the trouble... if you’re leveraged at 30:1, it only takes a small drop in the value of those assets to wipe out your starting capital. In this case, any more than a 3.33% decline on your assets would mean that you owe more money (your debts) than what you own (your assets) and therefore you are bankrupt!

Universal banks know however that contrary to other firms on the market, states will do everything they can to prevent them from going bankrupt. This is a key factor of the risky financial system we live in and little has changed five years after the crisis (See Finance Watch’s “Change Finance!” campaign to find out why). This is how banks’ big losses are socialized whilst their profits are privatized: society can only lose!
How did policy-makers realise that large universal banks were a problem?

One key lesson we learned from the 2008 financial crisis is that the US housing boom and bust, of unprecedented proportions, was more serious than previous busts largely because of the interaction of commercial and investment banking (Click on the image for a great 10 minutes animation to understand the US subprime crisis).

What had happened was that the mortgages taken out by citizens with their commercial banks were converted into tradable financial assets by investment banks, and then sold to other banks and investors all over the world. When the housing bubble burst, governments were forced not only to save deposit banks but also investment banks because of their trading activities. This was because banks had become too connected to each other via their trading activities, so that the failure of one bank could provoke the failure of many other banks. This interconnection was partly fed by the cheap funding that investment banks could get as part of a large universal bank.

Isn’t it ironic to imagine that when citizens bought a house, probably to ensure a safer future for their family, they were unknowingly involved in a global housing boom whose explosion instantaneously affected the whole financial system, hence the global economy, and their children will have to pay for this?

We’ve been here before

In the aftermath of the 1929 crash, the major financial crisis of the 20th century, lawmakers in the US approved legislation to split commercial banking entirely from investment banking.

- In 1933, four years after the 1929 crash, Franklin D. Roosevelt signed the Banking Act, which included provisions on splitting banks that became known as the Glass-Steagall Act.
- In 1999, Bill Clinton repealed those provisions to allow the creation of universal megabanks, which led within a decade to the worst financial crisis since 1929.

Policymakers around the world have since made a variety of proposals to separate bank trading from bank lending.
The European Commission’s legislative proposal

Bank separation has been on the EU’s agenda for two years already. In October 2012, a High-Level Expert Group (HLEG) appointed by the European Commission and led by the Governor of the Bank of Finland, Erkki Liikanen, made a series of recommendations in favour of a separation of banking activities.

The HLEG underlined the importance of decreasing the complexity of banks, making them easier to resolve (or wind up) if they get into trouble, and so reducing the risks for depositors, customers and taxpayers.

The Barnier proposal

The EC’s legislative proposal, published in January 2014 by the EC’s outgoing Commissioner for the Internal Market and Services, Michel Barnier, is a follow up to the HLEG’s report. Its objectives are to make banks safer and easier to resolve, to promote fairer competition among banks, avoid resources misallocation, and reduce conflicts of interest inside universal banks, among other things.

The right objectives, a mechanism that could be a major step forward, if sufficiently reinforced.

These are exactly the right objectives for a law on bank separation. The EC proposal puts forward a mechanism for actually separating bank activities that is not perfect but that is a big step in the right direction. The text related to the mechanism needs to be reinforced: question marks hang over how and who decides if a bank’s trading activities should be separated. Instead of a simple rule to require separation, there is potential discretion for national supervisors and some complexity.

Responsibility for Mr Barnier’s text will pass to his successor towards the end of 2014, meaning the fate of the proposal will likely be decided in 2015, no doubt amid a large amount of lobbying from large universal banks and their supporters.

See our Tokitoki Timeline for details of other bank structure proposals around the world
**PART 2: THE DEBATE AND FINANCE WATCH’S POSITION**

Debunking the myths of the banking lobby

As you can imagine the financial industry has lobbied hard - and with some success - to weaken the various legislative initiatives in progress around the world. They have tried to create a climate of fear among politicians by saying that banking reform would hurt the economy. In fact, reforming bank structure is something to be welcomed: it is a vital step in returning Europe’s banks and economy to health. Here are some of the arguments used and Finance Watch’s response to them.

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<th><strong>Banking lobby</strong></th>
<th><strong>Finance Watch</strong></th>
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<td>“We have done enough bank reform already!”</td>
<td>Quantity does not mean quality. Nobody is measuring if the new legislation will avoid a crisis in the near future. Important reforms are still not being done.</td>
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| “A bank separation would hurt the real economy!” | Hardly. On the investment banking side, only a small percentage of activity relates to non-financial firms. Less than 10% of debt securities issued, less than 10% of OTC derivatives and less than 5% of foreign exchange trading involves companies in the real economy. On the lending side, only 28% of EU bank assets are lent to households and companies. Separation can be part of a solution to restore “real economy” lending to the heart of a commercial bank’s profit strategy. |

| “The profits from trading activities by investment banks subsidise lending to the real economy!” | No, it is the other way around. Profits from trading are artificially boosted by the regulatory protection for essential banking services. |

| “Bank separation could produce two systemic banks in place of one!” | This line of argument does not hold: the resulting banks will be smaller and less interconnected than one definitely-much-too-big-to-fail bank. Separation will reduce contagion possibilities as firebreaks are put between commercial and investment banking activities in the same group. |

| “Only the investment firms in the US had problems (see Lehman). French banks for example did great, large German banks as well.” | Who do you think saved large German and French banks who had financial contracts in place with AIG or invested in Ireland that went almost bust? The US and Irish taxpayers! It is the interaction of commercial and investment banking and the immediate transformation of loans into tradable assets that created a housing boom of unprecedented proportions, the explosion of which affected instantaneously the whole financial system, hence the global economy. Welcome in the globalized world! |
Overview of legislative initiatives in Europe

Policy-makers agree on the reasons why banking activities should be split. They also recognize that it needs to be done “in good times” because the separation of bank activities in the middle of a crisis is not only impractical but could be more costly and damaging for the real economy. The only questions are what and how to separate.

Several European countries have already adopted national reforms to banking structure, increasing the pressure on the EU to adopt a harmonized approach.

France

France implemented a law on “séparation et de régulation des activités bancaires” on 26 July 2013. In the current state of the bill, the objectives announced by the Government will not be achieved. In other words, the French law to separate and regulate banks will separate almost nothing and change almost nothing... To read Finance Watch’s views on the weaknesses of the French reform, click here.

Germany

Germany passed a similar reform on bank structure on 7 August 2013, which became effective in parts from the end of January 2014. Like its French counterpart, the reform fails to separate the credit activities of very large banks from their trading activities. For instance, the vast majority of Deutsche Bank’s EUR 60,000 billion (around 23 times Germany’s Gross Domestic Product...) underlying notional amount of derivatives outstanding will be left untouched by this banking bill despite the Bill’s objective to separate risks and to protect both the taxpayer and depositors. To read Finance Watch’s views on the weaknesses of the German reform, see our Position paper on German bank reform, 22 April 2013.
United Kingdom
The Financial Services (Banking Reform) Act became law in December 2013. Its central idea is to “ringfence” deposit banks from investment banks inside the same banking group.

Similar in concept to the HLEG proposals, it would allow banking groups to have investment banking and commercial banking subsidiaries under the same holding company, as long as each has its own capital and its own governance structures. It is arguably the strongest of the European bank reforms so far. But a lot could happen before banks are required to comply with the law, in 2019.

Finance Watch has published a contribution to the UK ring-fence debate on 14 February 2013.

Belgium
The Belgian government as well is working on a reform proposal which is expected to be presented to the Belgian Parliament and to the public end of February 2014. As we are writing these lines, we still cannot comment on the content of the proposal. While there seemed to be an ambitious proposal on the table in the beginning that was suggesting a separation of all market activities beyond a threshold of 15% of total assets, the latest versions of the text show a clear setback.

Click and read more: Useful links
- “Change Finance” Online dossier & campaign
- Webinar “Bank separation” (February 2014)
- Webinar “What do large banks do?” (April 2013)

Finance Watch technical positions
- Report “The importance of being separated” (April 2013), one page summary
- Report “Europe’s Banking Trilemma” (September 2013)
- Contribution to the EU consultation (July 2013)
- Contribution to the German bank reform (April 2013)
- Contribution to the UK ring-fence debate (February 2013)
- Contribution to the French bank reform (January 2013)

Latest articles
- Finance Watch’s press release on the European Commission’s proposal (30 January 2014)
- Blog article about the EC proposal (21 February 2014)
- Blog article on the results of the public consultation on the separation of banking activities (November 2013)

European Institutions documents and website
- Liikanen report
- European Parliament report 24/6/2013
- European Commission’s proposal 29/1/2014
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