Too Big to Regulate

Remarks by
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The Theme:

Is size a problem for banking regulation?

Preliminary (and much broader) question: Should bank size be regulated?

Plan of this discussion:

1. Are banks big?
2. What are the reasons for banks' being big?
3. Why bank size is not a problem for banking regulation
   Why bank size is a problem for banking regulation
4. Too big to supervise?

1. Bank Size

Observation:

Globally 2008:
- 12 banks with balance sheets of more than $1,000 bn
- Top 5 from Europe

Globally 2017:
- 28 banks with balance sheets of more than $1,000 bn,
- Top 5 from China or U.S. (JP Morgan Chase, IFRS adjusted)

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2. Why Are Banks Big?

Economies of scale and scope:

- Data and work of the 1980s: economies of scale only up to very moderate levels of balance sheet size, beyond those diseconomies of scale.
- Data and work of the 1990s: Some economies of scale, optimal balance sheet size \$10 – 25 bn. Largest estimate by Berger and Mester (1997).
- Most recent work: In the U.S. “we find large scale economies at small banks and even larger scale economies at large banks” (Hughes and Mester, 2013).

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Reasons for this change of findings (Hughes-Mester):

- Change in banking production functions (such as use of information technologies)
- Deregulation in the U.S. (allowing, e.g., geographic diversification)
- Better economic models to measure and evaluate bank production functions

Key argument: risk and return.

A closer look at risk and return: (Demirgüc-Kunt and Huizinga, JFI 2013):

Globally 2008:
- 12 banks with balance sheets of more than $1,000 bn,
- 30 banks with balance sheet greater than 50% of home GDP.

Bank	Liab ($bn)	Liab/GDP
UBS	1852	3.7
ING	1813	2.2
Credit Suisse	1058	2.1
Danske Bank	652	2.0
Dexia	900	1.9

According to Demirgüc-Kunt, Huizinga (2013):
- Large absolute size → higher M2B ratio and higher risk
  higher M2B ratio controlling for risk

Interpretation:
- Large banks profit from more risk-taking because they can take more risk per unit of capital and manage larger risks better.
- have a limited downside because of too big to fail (TBTF) → lower funding costs

Countervailing effect:

- Large absolute size → higher M2B ratio and higher risk
  higher M2B ratio controlling for risk
- Large systemic size → lower M2B controlling for risk

Interpretation:
Systemically large banks are valued at a discount because the TBTF subsidy is less likely: too big to save (TBTS).

Hence, question is not whether banks are too big in absolute terms or up to which point there are economies of scale, but:

Question: Are banks too big systemically?

Assessment: Large banks have become too big systemically

- TBTF: In case of distress, governments have a strong incentive to intervene and bail out (ex-post transfer).
- TBTS: In the (rare) event of banking failure, economy suffers from the ensuing destruction of financial infrastructure, or from national bankruptcy (Iceland, 2008).
- Systemic bank size and market power are highly correlated
  → competitive distortion → Competition policy??
- Too big to manage (JP Morgan Chase's "London Whale")
- Political power of large banks (S. Johnson, J. Kwak, 2010)

Cautionary note: What is the reference economy? A bank that is large in Belgium is small in the EU.

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3. Too big to Regulate ?

Classical tools of macroprudential banking regulation:

- Activity: Glass-Steagall, ringfencing (Vickers, Liikanen), Volcker Rule (Sec. 619 Dodd-Frank), …
- Balance sheet: liquidity coverage ratio, net stable funding ratio, …
- Accounting: netting and offsetting (IFRS 7), off-balance sheet items, consolidation of subsidiaries, …
- Financing: capital requirements, leverage ratio, Riegle-Neal
- Ultimately: size restrictions (very weak version: Sec. 622 of Dodd-Frank)

Note: These tools are all size-independent!

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Observation: Banks are not too big to regulate, the tools are there to use.

Observation: The problem of bank size is different across continents:

- U.S.: Several systemically important banks:
  - 6 banks with assets > $ 1 tr. (IFRS adjusted) in 2017
  - Note: assets/GDP at $ 1tr.: 1/19.4 = 5%
  - 6 largest banks control 54% of retail current accounts
- Europe: National markets are much smaller. E.g. U.K:
  - 4 banks with assets > $ 1 tr. in 2017
  - HSBC assets/GDP = $2,520/$2,600 bn = 97%
  - 6 largest banks control 87% of retail current accounts

Observation: Europe has the wrong sort of large banks: national champions instead pan-European heavyweights.

Case for cross-border mergers is well known in the industry. E.g. S. Ermotti (CEO, UBS): “The topic is ‘too small to survive’, not ‘too big to fail’” (2018, 2019).

Key problem: Politics

- European banking union still not completed (despite significant progress).
- Desire by EU governments to keep their financial sectors national
- Political preference for national concentration rather than European diversification

Case study: Acquisition of Dresdner Bank by Commerzbank:

- Acquisition of Dresdner Bank by Allianz in 2001 for €30.7 bn.
- Losses in retail and in investment banking (Dresdner-Kleinwort-Wasserstein) ever after
- 2008: Loss €6.3 bn, equity/assets < 4%
- Acquisition by Commerzbank for €9.8 bn. (announced 8/2008)
- Nov. 2008: Commerzbank receives €8 bn. government bailout. May 2009: Further €10 bn. in exchange for a 25% equity stake.

- Dec. 2018, Bloomberg: “The German finance ministry is willing to ‘orchestrate’ a merger between Deutsche Bank AG and Commerzbank AG …”

Observation: The segmentation of the European banking market has created a political ‘Too big to regulate’ problem in Europe:
- small regulators – large banks
- home regulator – host regulator
- branch – subsidiary regulation

EBA: Harmonization, centralization, and professionalization.

How much, how deep, how fast?

Too big to supervise

Basic problem: too big to manage
→ simply elevated to a new level

Tradeoff: Proximity vs. regulatory capture

Example:
Danske Bank (Copenhagen) vs. Finanstilsynet (Copenhagen)

Conclusion

Conceptually, bank size is more likely to be a problem for supervision than for regulation. The regulatory stance is a political decision.