SwissBanking

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Does Switzerland need big banks?

Banks in international comparison

SBA discussion paper

Does Switzerland need big banks?

The lessons learned from the global financial crisis ten years ago were manifold. As a result, banks increased their capital resources and improved their risk management. Numerous other measures were introduced to ensure that distressed banks no longer pose a risk to taxpayers in times of distress. Although all financial centres had the same objective at the time, we are now seeing a significant divergence in the ensuing developments. Big US and Chinese banks have experienced strong growth in the last decade, while big European banks have contracted significantly. Of economic relevance is that as a result, a disparity has also arisen in terms of profitability and the comprehensiveness of services offered domestically.

Overview

- Despite global measures to address the causes of the financial crisis, the disparity in terms of the size and profitability of big US and European banks is growing.
- The reasons for this are the consolidation following the rapid remediation of legacy issues at US banks and the stagnation of the EU banking union.
- National security thinking hinders banks in Europe from successfully implementing international business models.
- A fragmented financial system particularly affects countries without global banks:
  - It makes it more difficult for local banks to diversify internationally. Financing risks are less easily absorbed.
  - Dispensing with certain types of business limits profit expectations and therefore capital accumulation.
  - The development of the banking sector hinges on the national economy.
  - Without domestic investment banking, access for larger companies to international capital markets depends entirely on other countries. This can result in less attractive conditions and in times of crisis, to a financing risk.
- The hidden costs that arise from a contraction in the size of banks must be taken into account in corresponding regulatory projects.
- The big Swiss banks are smaller than they were ten years ago and have repositioned themselves. They are well capitalised and meet the TBTF requirements.
- Controlled growth allows them to fulfil their role in the domestic economy and reinforces the global importance of the Swiss financial centre.

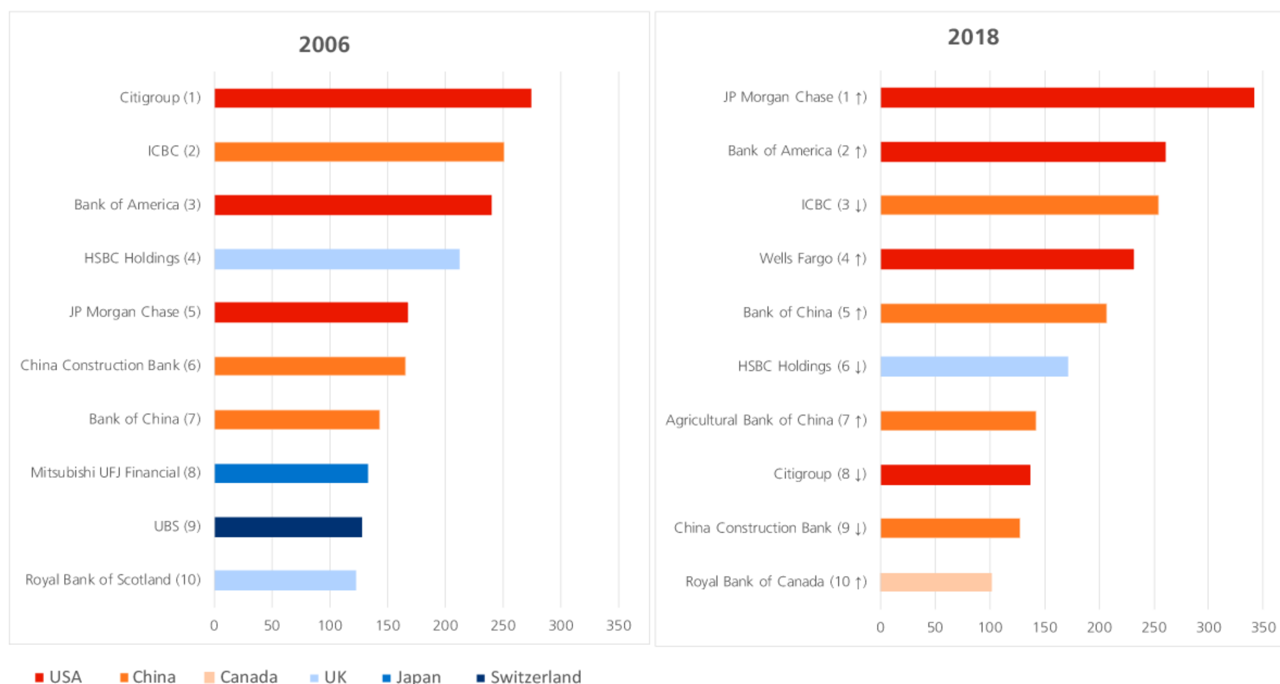
The global financial crisis underscored the fact that large and internationally interconnected financial institutions can represent major risks for an economy. In the event of their failure, functions that are indispensable for the smooth functioning of the economy can no longer be performed. These include lending and the execution of payment transactions. Such banks are too big to fail (TBTF) and if necessary, are rescued by the state.

In the wake of the financial crisis, politicians in Switzerland called for a significant reduction in the size of the banks' balance sheets in order to protect taxpayers. However, many now see the resulting contraction as an expression of weakness. The media even made a recent mention of the Marignano of the Swiss banks. The fact that many European banks are in part even more affected by this development is of little comfort.

Considering the Swiss efforts to contain the risks associated with too-big-to-fail, it seems questionable that capitalisation – above all of US banks – has increased to an extent that belies there was ever a financial crisis. The Chinese banks also saw strong growth during the economic upturn. The European banks can therefore now hardly be considered leaders in terms of market capitalisation (see chart) or balance sheet totals.

Market capitalisation of the ten biggest banks per region: 2006 and 2018

Compared to before the financial crisis, the market capitalisation of US and Chinese banks has increased, while European and Japanese banks have contracted (in billion USD).



Source: DBresearch.de, Macrotrends.net, Reuters.com

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Reasons for the diverging paths

One of the primary reasons for the differing developments in Europe and the US is the much faster and more radical remediation of the legacy issues in US banks' balance sheets, which was supported by the government. This led to swift consolidation, resulting in ever larger institutions which are well equipped for the future.

We know how the rest of the story goes: while the Americans got to work, the Europeans spent a long time clarifying who was responsible for what. During the recession that followed, there was a lack of strength and determination in many EU countries to undertake painful interventions and decouple financial institutions from the state. The prolonged period of low interest rates then took effect, meaning that the European banks, which are rooted in the interest-rate business, did not have the fertile ground they needed in order to recover.

Almost no one denies that Europe is currently overbanked. If the financial crisis did not result in a simplification of the banking landscape, digital business models could instead provide the impetus for consolidation.

EU banking union in a holding pattern

Practically all financial institutions passed the latest ECB stress test. However, many are still far from being highly profitable or developing dynamically; a few of them are actually in a dubious state.

This is likely the primary reason for the standstill in the establishment of the EU banking union, which is to serve as the centralised banking supervisory body and resolve banks in the event of illiquidity. However, the EU banking union cannot start out with fragile banks and be considered a trustworthy project. On the other hand, excluding distressed banks would stigmatise these institutions and subject them to even greater pressure. But a banking union in particular is a key prerequisite for big pan-European banks.

Fragmentation of the financial system

Without the banking union, the financial system remains one in which states protect their taxpayers by ring-fencing, but in doing so, also encourage fragmentation. Global banks can no longer put their capital where it can be used most productively. This hinders risks from being balanced internationally. Stability is no longer achieved by spreading risks, but by the deleveraging or the reduction of risks by the banks. This risk reduction resulted in a credit crunch in many countries following the financial crisis.

The combination of a lack of consolidation despite a problematic trend in revenues and national security thinking is hampering the European banks' opportunities for development. Taking advantage of such opportunities is, however, necessary in order to address the increased competition from abroad and from the non-banks with digital business models, which have not been encumbered by the crises.

Competitiveness and stability
Big banks with an international presence can diversify more easily and absorb financing risks accordingly. The example of the US shows that this can have a positive impact on profitability and the organic accumulation of capital for institutions.

The International Monetary Fund is concerned about the lack of profitability in the European banking sector, which is still waiting to be liberated. For banks with a domestic focus, business performance is therefore closely linked to the overall economic trend. Accordingly, the growth problems that exist in a number of European states have already translated into a risk for the commercial banks.

The disparate developments in terms of growth can, however, also undermine our efforts to achieve greater stability at home. Increasingly important US institutions can provide impetus for the global financial system.

Regulation in Switzerland focuses on absorbing shocks. However, the differing trends developments in terms of size and revenues also reflect a playing field that is not level. This adversely impacts Switzerland's relative competitiveness. It is therefore important that in accordance with good regulatory policy, the costs of additional regulatory requirements also be taken into consideration during the decision-making process.

Dependence on other countries a risk for industry
Additional risks exist for a country without domestic big banks that offer investment banking services. In such cases, larger companies depend entirely on other countries for access to international capital markets. If industry in a country relies wholly on a small number of US banks for new capital, mergers and other important intermediation services, this results in a number of risks.

First, this market concentration can result in oligopolistic behaviour. Second, in a crisis, global lenders usually retreat to their home market and in doing so, put the brakes on the international flow of capital. Without domestic providers who can step in as alternative lenders to US banks, the domestic economy is exposed to a financing risk.

Switzerland is one step further
The big Swiss banks have also contracted and repositioned themselves. For example, they are among the top players in the global asset management business. However, they are well capitalised and meet the TBTF requirements. Controlled growth on a healthy basis is not only important for institutions, however, as they also make an important contribution to the domestic economy through their role in international business.

Of particular importance in this area is the international reach of the Swiss financial centre. Because one thing is clear: without banks that operate globally, Switzerland is not a global financial centre. And this means fewer jobs and less ability to set the agenda.

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Are you interested in this topic and do you have an opinion on the matter? Our experts look forward to hearing your thoughts and would be happy to exchange ideas with you.

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