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Banking On Our Future:

The Value Of Big Banks In A Global Economy

We are no longer living in the times of George Bailey. Big banks are not only competing with the Mr. Potters of the next town over, but with large and powerful institutions from around the globe.

Imagine a scene in "It's a Wonderful Life" where a company asks George Bailey to provide a multibillion dollar line of credit or raise hundreds of millions of dollars in a couple of days to help a company meet its capital needs. Add to that a scenario where the companies were operating across foreign countries with multiple currencies and regulatory regimes.

The truth is that the U.S. needs both large multinational banks and small community banks in order to service the needs of the U.S. and global economies, provided that they are run safely with sufficient capital and liquidity appropriate to their business operations.

This paper is divided into two broad sections. The first section examines oft-neglected facts about the largest U.S. banks in the break up the banks debate: the value of large banks to the global economy and their growth over time, the dramatic improvements in safety and soundness over the past three years, and the context of international competition. The second section explores the consequences of ignoring these facts by breaking up the banks. Specifically, which financial institutions will meet the needs of the U.S. and global economies if the largest U.S. banks are broken up?

In the event the largest U.S. banks are broken up, the global competitive landscape will rebalance in favor of foreign banks and the nonbank financial sector. This will place U.S. banks at a competitive disadvantage for banking services and is likely to have negative unintended consequences on the control and flow of credit in the economy.

Key Findings:

- U.S. banks are already smaller and safer than their global competitors
- The loan syndication market is no substitute for big, global banks
- In the event of a break up, the global competitive landscape will rebalance in favor of foreign banks and the shadow banking sector
- Ultimately, breaking up U.S. banks will not improve the safety of the global financial sector and would reduce U.S. influence over the financial sector globally

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In a breakup scenario, large European, Japanese, and Canadian banks, will gain market share in the short-run. In the long-run, Chinese banks, and other growing nonbank financial institutions in the shadow banking sector, stand to gain the most.

The U.S. regulatory system, and the economy as a whole, benefits from a large, domestic-based financial industry. Moreover, U.S. regulators have more authority over U.S. banks than they do over foreign banks and the shadow banking sector. In a world fraught with risk, it is to America's advantage to have proximate control of capital, and safety and soundness, rather than to cede its authority to countries and institutions that may have conflicting interests.

Ultimately, breaking up U.S. banks will not improve the safety of the global financial sector and would reduce U.S. influence over the financial sector globally.

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Section 1: Big Banks Today In The Global Economy

The rise of big banks over the past several decades reflects dramatic growth and increased interconnectedness in the global economy and its financial needs. Global banks act as a platform for U.S. multinational companies and U.S. investors to manage and execute various financial management strategies.

Recent regulation has helped address many concerns brought about from the recent financial crisis. Data shows that the U.S. financial sector is dramatically safer than pre-crisis. Dodd-Frank reform and Basel III have led to improvements in safety and soundness. The creation of "living wills" provides an outline for how a firm can fail without damaging the broader economy, and new legal authority for liquidating failing firms now exists as a viable option for regulators. New agencies exist to explicitly monitor systemic risk in the financial sector, provide ongoing oversight, and thought leadership in the field. The regulatory overhaul is far from finished, as new rules have yet to be implemented. All these developments have and will continue to contribute to a less crisis-prone financial sector where no firm is too big to unwind.

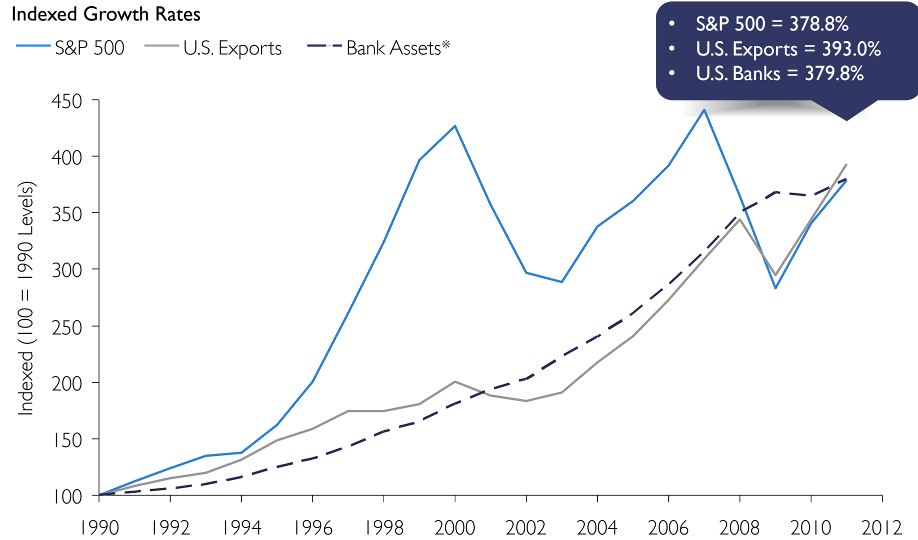
The Global Economy And Its Financial Needs Have Grown Exponentially

The discussion surrounding breaking up the banks often downplays the value of big, global banks to the U.S. and global economy. Critics have painted the picture of an out of control, large banking sector that must be reined in. Yet, the data shows that the U.S. banking sector has actually grown proportionately with the rest of the

economy (Exhibit 1). U.S. exports and the S&P 500 have both grown at the same rate as the assets of U.S. banks over the past two decades.

Exhibit 1

GROWTH OF THE U.S. BANKING SYSTEM IS CLOSELY TIED TO GROWTH OF THE U.S. ECONOMY



Source: Federal Reserve Bank of St. Louis
*U.S. Commercial Banks

Much of the expansion came from large U.S. companies that now employ roughly 20 percent of all U.S. workers. Over the past decade, non-U.S. revenue as a percent of total revenue increased by 14 percent for the top 50 companies in the U.S.[1] Large companies like Wal-Mart now receive more than 20 percent of their revenues from foreign countries. Other well-known multinationals, such as Ford Motors, receive roughly 40 percent, while oil and gas producers, such as Exxon Mobile, receive well more than 50 percent of its revenues from countries outside of the U.S. According to the "World Investment Report," foreign direct investment (FDI) from developed countries like the U.S. rose 23 percent in 2011. In addition, countries outside the U.S. are also heavily investing in U.S. companies; for example, Japanese firms doubled mergers and acquisitions of U.S. and European companies over the same period.[2]

Some critics say the problem is not the growth in the banking sector itself, but the concentration of assets among individual banks. During the recent financial crisis, some large banks consolidated their institutions with failed banks and other institutions that seemed a bargain at the time. Thus, the narrative states that through government subsidies and government-supported mergers, individual banks that were "too-big-to-fail" got even bigger.

[1] "Scaled to Serve: The Role of Commercial Banks in the U.S. Economy," The Clearing House, July 2012.
[2] "World Investment Report 2012," UNCTAD, July 2012.

Many banks did grow over the last several decades; however, growth of the largest U.S. banks did not outpace the growth of the global economy.

For example, in a Milken Institute working paper titled "Just How Big Is the Too Big to Fail Problem?" Barth, Prabha, and Swagel analyze the composition of the world's largest banks over time. Based on the assets of the world's 50 largest banks, big U.S. banks had a global market share of 40 percent in 1970, the largest share at the time, totaling roughly $170 billion. That quickly changed. Due to increased international competition and the expansion of global finance, by 1990 the market share of big U.S. banks decreased to a mere three percent of the top 50.

This does not mean U.S. banks lost assets over this period. On the contrary, the largest U.S. banks increased their holdings to $297 billion by 1990; however, big U.S. banks were not on the receiving-end of the global expansion from that period. Essentially, U.S. banks were at a competitive disadvantage in the global economy and rapidly losing market share to banks throughout Europe and Japan.[3]

"U.S. banks were at a competitive disadvantage in the global economy and rapidly losing market share to banks throughout Europe and Japan."

Although the global economy was growing at a rapid rate prior to 1990, the growth that occurred post-1990 makes the prior expansion look miniscule. New data from 2011 shows that the biggest U.S. banks have regained global market share, however, not to the levels seen since 1970. The biggest U.S. banks now hold 15 percent of the assets of the top 50 banks, representing $9.8 trillion. And although the U.S. economy is larger than all others, large U.S. bank market share falls in line with those of most developed economies. This is in line with the market shares of other developed economies. This data reflects that big U.S. banks face a highly competitive global industry, and although their size has increased over the past few decades, size correlates closely with that of the growth in the economy.

Globalization Of The Economy And Financial Assets

What caused such large growth in the banking sector? Globalization - the world economy and its global financial needs got bigger. According to a report released by McKinsey & Company, *Mapping Global Capital Markets 2011,* the global stock of financial assets has grown over 1,000 percent in the past two decades (Exhibit 2).[4]

This growth reflects the value and volume of portfolio investments, private and official credit instruments, and new capital markets in Asia, Latin America and Africa.

[3] Barth, Prabha and Swagel, "Just How Big is the Too Big to Fail Problem?" Milken Institute, March 22, 2012.
[4] Lund, Piotrowski and Roxburgh, "Mapping Global Capital Markets 2011," McKinsey Institute, August 2011.

More broadly, the data underscores how economic growth is connecting financial markets throughout the globe.

Exhibit 2

GLOBAL FINANCIAL STOCK HAS INCREASED MORE THAN 10X IN JUST 20 YEARS

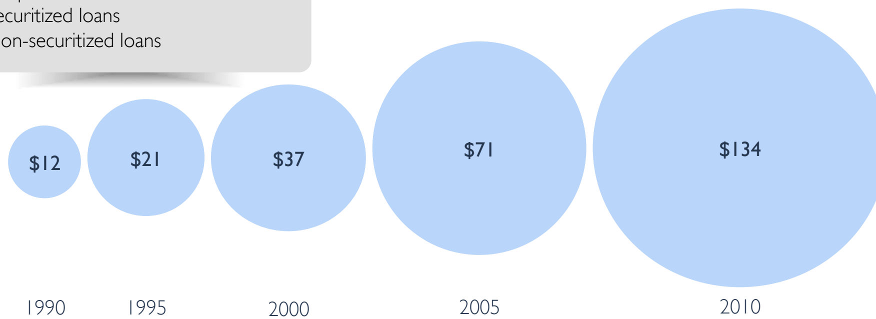
Global stock of debt and equity outstanding ($ In Trillions, not including derivatives)

Global stock of financial assets includes:

- Stock market capitalization
- Public debt securities
- Financial institution bonds
- Corporate bonds
- Securitized loans
- Non-securitized loans

Financial needs have also become more connected.

- Global foreign exchange activity tops $4 trillion a day.
- Cross-border flows increased ten fold in the 20 years before the crisis



Source: HPS Insight, McKinsey Institute

On a macroeconomic scale, cross-border flows, such as FDI, increased tenfold from 1990 to 2007. The daily turnover of foreign exchange now tops $4 trillion dollars. And U.S. trade (exports and imports) has increased four times its 1992 level. The combination of growing markets and increased interconnectedness has led to a significant need for global institutions that can efficiently serve companies by managing, financing, producing, and selling across a complex supply chain and an increasingly global customer base.

Global Banks Make A Complex World Simple

Based on a study by the Federal Reserve Bank of New York, the top seven U.S. bank holding companies (BHCs) have more than 4,800 foreign subsidiaries spanning up to 80 countries. A number of these subsidiaries are in Europe, but they also exist in emerging markets such as Africa, Asia, and Latin America. The remaining top 50 banks have just over 1,000 foreign subsidiaries. Outside of the top 50, subsidiary ownership outside of the U.S. is basically non-existent. Clearly, the largest banks are in a league of their own when looking at the global economy.[5]

[5] Avraham, Selvaggi and Vickery, "A Structural View of U.S. Bank Holding Companies," The New York Federal Reserve Bank Economic Policy Review, July 2012.

In many ways, global finance has moved from a hub and spoke model, where previously only a few dominant financial centers existed, to a network model, where capital can now flow more efficiently all over the world.

Critics are quick to claim that efficiencies disappear once a bank passes a specific size. Some studies argue that there are not benefits from economies of scale and scope for banks with more than $100 billion in assets.[6] Thus, they argue, breaking up banks will not cause any harm to the U.S. or global economy.

"The financing of multinational companies is a direct competition between large U.S. banks and large foreign peers, not smaller, regional banks."

However, these analyses treat global banks like smaller regional and community banks. They analyze efficiencies based solely on taking deposits and making loans. Global banks do these activities, but they also provide trade finance, securities underwriting, currency hedging and interest rate risk management, transaction and payment services, supply chain management technologies, and offer billion dollar lines of credit in countries throughout the world. They provide a platform for an array of services to help U.S. multinational companies manage their finances. In this business, there are significant economies of scale. In summary, they are involved in the global relationship management business for large nonbank companies.[7]

While regional and smaller banks can serve the interest of many small and mid-size businesses, global banks are platforms for companies executing financial and business strategies across the globe. In this capacity, there are efficiencies in both size and platforms. When looking at recent changes in the global economy and the makeup of financial assets, the value of having global banks will only increase.

Do nonbank companies agree? According to Thomas C. Deas, Jr., treasurer of chemical company FMC Corp., they do. He says, "Treasurers of U.S.-based multinationals rely on large banks able to provide global services and credit support around the world." Additionally, services required by multinational companies have "resulted in a smaller group of more capable banks making bigger individual credit commitments. This structure would not be supported by breaking up banks with the consequent lower statutory lending limits."[8]

[6] Johnson, "Big Banks Are Hazardous to U.S. Financial Health," Bloomberg View, September 2, 2012.
[7] Calomiris, "Forefront: Interview with Charles Calomiris," Federal Reserve Bank of Cleveland, February 2, 2011.
[8] Aspan, "Are Giant Banks Indispensable? No, Says Big Business," American Banker, August 21, 2012.

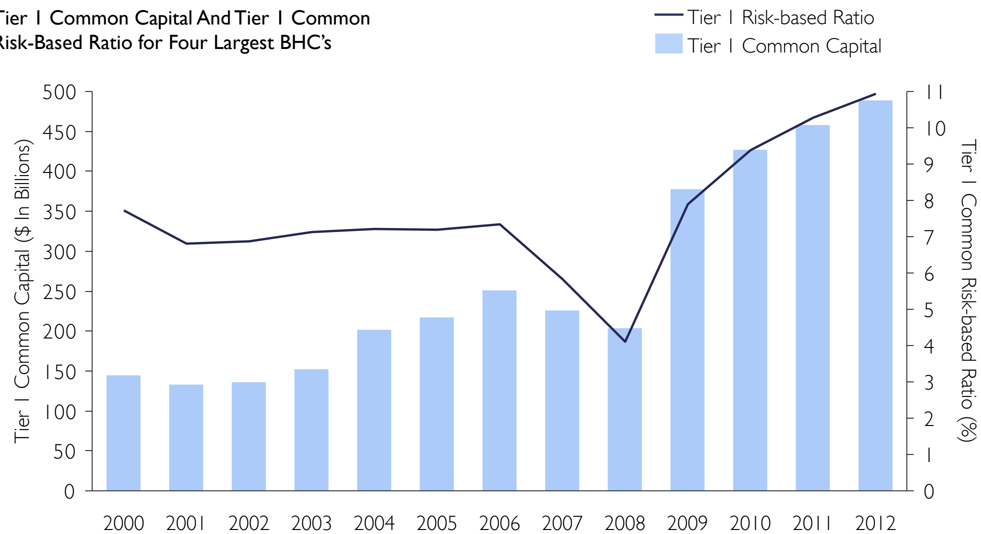
Big U.S. Banks Are Significantly Safer Than Prior To The Crisis

Break-up proposals also ignore the very real and beneficial changes to the U.S. banking system over the past three years. The largest changes have occurred with bank capital, liquidity, and the newly created powers to deal with failing institutions.

The four largest banks in the U.S. are currently JPMorgan Chase, Bank of America, Citigroup, and Wells Fargo, respectively. Collectively they have increased their Tier 1 Common Capital by 140 percent since the crisis. As a percentage of risk-weighted assets, this rapid increase has led to a 166 percent increase in their combined Tier 1 Common Risk-Based Ratios to an average of 10.95. This represents a significant increase from their average during 2001 to 2007 of 7.06 percent (Exhibit 3).

Exhibit 3

LARGEST FOUR BANKS HAVE IMPROVED CAPITAL LEVELS AND CAPITAL RATIO DRAMATICALLY SINCE THE CRISIS



Source: FDIC, SNL Financial, HPS Insight

Not only is their level of capital higher, but the four largest U.S. banks also have higher quality capital. Tangible equity has increased from an average of just above five percent of tangible assets over the periods of 2001 to 2007 to a high of eight percent today.

The largest four banks are also more liquid than at any time in the past. Prior to the crisis, these banks held a large share of loans to deposits. A central problem during the crisis was an over-extension of the industry's core-funding. Now the loan-to-deposit ratio is just under 80 percent. This improvement is partially cyclical, as loan demand has decreased; however, Dodd-Frank and Basel III reforms are being

implemented to ensure these improvements are not temporary, but more permanent features of a safer and sounder financial system moving forward.

Dodd-Frank reform also addresses a key concern surrounding the issue of moral hazard. By recapitalizing institutions during the crisis, the government risked giving investors the impression that big banks were a risk-free bet. If this perception took hold, the argument follows, big banks could more cheaply fund their operations than their smaller competitors could.

This argument is wrong for two reasons. First, a natural funding advantage already exists for large banks due to their access to capital markets and diversification in revenue. Many critics have yet to provide substantial evidence for a too-big-to-fail funding advantage on top of this, yet it is referenced enough in public discourse to be accepted as a universal truth - it is not.

Second, the FDIC's new Resolution Authority gives regulators the tools it needs to wind down a large, failing institution. This helps eliminate any potential funding advantage big banks are thought to have. Dodd-Frank altered the market incentive to invest in the debt of large financial institutions by mandating losses in the event of failure. Convincing the market that bondholders will take losses is not a simple task, though credit rating downgrades by Moody's is a sign of progress on this front.

U.S. Banks Are Not The Largest Among Global Players

Thomas Hoenig, former President and CEO of the Kansas City Fed and now a Director of the FDIC, attempts to address concerns that breaking up U.S. banks will not place them at a "competitive disadvantage relative to global banks, mostly from Europe, that are allowed to conduct the full range of [banking] activities." Hoenig states that there is little risk that U.S. banks will move abroad. By not moving abroad, he argues, there will be no net loss to the U.S. economy.[9]

His assumption that companies will not move abroad may be right, but it misses the point. Many foreign competitors are already larger than U.S. banks in terms of assets, namely those in Japan, Europe and China on a U.S. GAAP basis (Exhibit 4).[10]

Foreign banks can and will provide multinational companies the services they need if U.S. banks were artificially forced to downsize. These foreign banks stand to gain from a break-up of the largest U.S. banks.

The U.S. banking system is compromised of a diverse set of institutions. Differences come down to services offered, the size of the institution, and their geographic footprint, reach, and place of origin.

[9] Hoenig, "Restructuring the Banking System to Improve Safety and Soundness," Federal Reserve Bank of Kansas City, May 2011.
[10] Barth, Prabha and Swagel, "Just How Big is the Too Big to Fail Problem?" Milken Institute, March 22, 2012.

Exhibit 4

U.S. BANKS ARE SMALLER THAN BRITISH, JAPANESE, AND CHINESE COMPETITORS BY ASSETS*

World's 15 largest publicly traded banks as of the fourth quarter of 2011 ($ In Trillions)

The largest U.S. bank is the fourth largest global bank by assets.

Rank	Company Name	Country	Assets ($)
1	Mitsubishi UFG	Japan	2.48
2	ICBC	China	2.45
3	HSBC	U.K.	2.43
4	JPMorgan Chase	U.S.	2.26
5	Bank of America	U.S.	2.12
6	BNP Paribas	France	2.07
7	China Construction Bank	China	1.94
8	Credit Agricole	France	1.91
9	Mizuho	Japan	1.90
10	Citigroup	U.S.	1.87
11	Bank of China	China	1.87
12	Agriculture Bank of China	China	1.85
13	Deutsche Bank	Germany	1.83
14	Sumitomo Mitsui	Japan	1.68
15	Barclays	U.K.	1.58

Source: The Clearing House.
*Asset data is as of the latest available reporting period. Banks presented on a US GAAP basis when available; otherwise, adjusted to exclude reported gross derivative assets for an estimated proxy for US GAAP derivative netting rules.

U.S. banks are not only competing with foreign banks abroad, but also here in the U.S. Foreign banks make up a sizeable portion of the U.S. banking system - domestically, foreign banks comprise more than 10 percent of the top 100 banks by assets, and 20 percent of the top 200.

> "U.S. banks are not only competing with foreign banks here in the U.S., but also abroad."

As discussed earlier, U.S. banks also compete abroad. They help finance U.S. multinational companies that have significant international business interests. Providing capital through lending may be the most well-known activity, but large U.S. banks also help companies with other services, many of which traditional retail banks do not offer. The benefits to both bank size and scope goes outside of deposit and lending capabilities.

Comparing Bank Size to Home Country GDP

If U.S. banks are considered small compared to global banks in absolute terms, U.S. banks are much smaller than global competitors in relative terms. Measured by taking a bank's assets as a percent of its home country GDP, data shows there are 24 foreign banks bigger than the biggest U.S. bank (Exhibit 5).

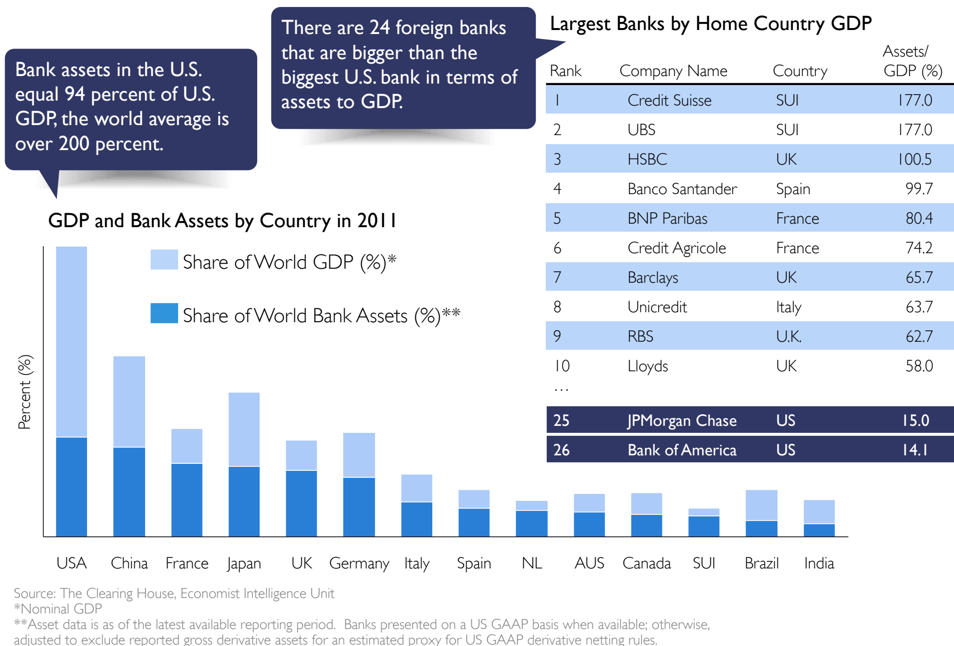
Many European banks are more than 100 percent of the size of their home country's GDP, and several European banks are more than 200 percent the size of their GDP. In contrast, the largest U.S. bank is less than 15 percent the size of the U.S. economy.

Adjusting for international accounting standards does not change the story. The top five U.S. banks hold assets equal to 56 percent of U.S. GDP, whereas the top five German and English banks' assets equal 116 percent and 309 percent of GDP, respectively.

U.S. banks are not trending toward the size and concentration associated within Europe. Compared to Europe, the U.S. system is significantly more competitive and less concentrated. Further, many foreign banks have significantly less capital and liquidity than their U.S. competitors do. According to McKinsey's "Annual Review on the Banking Industry," banks from all regions throughout the globe sharply increased Tier 1 capital since 2007; however, U.S. banks hold the highest levels of capital compared to all others.[11] Because many foreign banks are larger than their domestic economies, they pose significantly more risk to their taxpayers than U.S. banks.

Exhibit 5

BASED ON HOME COUNTRY GDP, U.S. BANKS ARE SIGNIFICANTLY SMALLER THAN FOREIGN COMPETITORS



Rank	Company Name	Country	Assets/ GDP (%)
1	Credit Suisse	SUI	177.0
2	UBS	SUI	177.0
3	HSBC	UK	100.5
4	Banco Santander	Spain	99.7
5	BNP Paribas	France	80.4
6	Credit Agricole	France	74.2
7	Barclays	UK	65.7
8	Unicredit	Italy	63.7
9	RBS	U.K.	62.7
10	Lloyds	UK	58.0
…			
25	JPMorgan Chase	US	15.0
26	Bank of America	US	14.1

Source: The Clearing House, Economist Intelligence Unit
*Nominal GDP
**Asset data is as of the latest available reporting period. Banks presented on a US GAAP basis when available; otherwise, adjusted to exclude reported gross derivative assets for an estimated proxy for US GAAP derivative netting rules.

[11] "McKinsey Annual Review on the Banking Industry," McKinsey Institute, October 2012.

Section II: Breakup Consequences

Even as debate rages over breaking up big banks in the U.S., there is comparatively little attention paid to the consequences of a break-up on the economy, nor is there consideration of what would take the role of the big banks as credit intermediaries.

One of the substitutes commonly proffered for a single big bank is a syndicated loan. Data reveal that the biggest U.S. and foreign banks dominate the loan syndication market in the U.S. and around the world. Given these market preferences, capping bank size will not result in more business for smaller U.S. banks, but instead will result in a giveaway to large foreign banks, and potentially open the door to the creation of new financial instruments.

In the short run, the largest foreign banks will fill the gap left by large U.S. banks. In the long run, those that exhibit the most growth in financial assets will fill the role as global financial leader. Current estimates for GDP and size of the banking sector show that China will be this leader; however, there is also the possibility that many financial services will move outside of regulated banking entities and into the shadow banking sector.

Small Banks Cannot Meet Global Funding Needs

Promoters of breaking up the largest U.S. banks mistakenly argue that small banks are substitutes. The theory goes that small banks can group together to underwrite large loans – otherwise known as a loan syndication. However, the data shows that large banks are a preferred funding source in the loan syndication process, and when there are not enough large U.S. banks, large foreign banks help underwrite loans, not smaller U.S. banks.

In a syndicated loan, an arranger typically brings together two or more banks that jointly agree to provide a loan. The arranger can also be an underwriter. Typically, the issuer pays an arranger a fee for investment banking services of raising capital, and as the complexity and riskiness of a loan increases, so does its cost. [12] Costs on a syndicate derive from diligence (legal and financial) on the companies involved, time it takes to get to market, creditor risk, and overall trust between the institutions involved.

The risk that the arranger(s) and underwriter(s) take on and the efforts to keep costs low is why the largest syndicated loans are with the largest banks that have both investment banking and traditional services. According to Jim Simpson, former treasurer and chief financial officer of a large pharmaceutical company, "If a commercial bank has a very good and prominent investment banking presence, it's going to have a decided advantage." Having smaller, specialized commercial banks

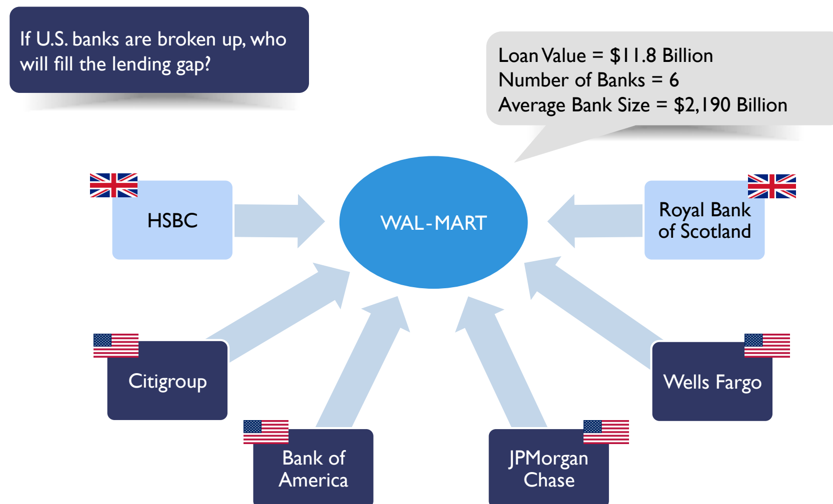
[12] Taylor and Sansone, "The Handbook of Loan Syndications and Trading,," LSTA, August 2006.

that cannot offer all services, or splitting commercial and investment banking, would add costly obstacles.[13] Moreover, while it is possible that smaller banks, nonbank financial institutions, and other investors can take part in the loan syndication process, the market preference is for global banks and will be until other firms can match the variety of services offered.

As of the third quarter of 2012, the largest syndicated loan in the U.S. went to the global retail chain Wal-Mart. The loan value totaled more than $11.8 billion (Exhibit 6). According to Bloomberg data, six banks participated in the loan underwriting process. Four of the underwriters were U.S. banks, which also happen to be the largest four U.S. banks by assets – a notable point in terms of the scalability of loan size. The other underwriters were two of the largest banks from the U.K. Not only did it take four of the largest U.S. banks, but the underwriting process also benefited from having additional large foreign banks due to the size and complexity of the loan.[14]

Exhibit 6

THE LARGEST U.S. SYNDICATED LOAN IN 2012 REQUIRED UNDERWRITING FROM THE LARGEST FOUR U.S. BANKS AND TWO FOREIGN BANKS



Source: HPS Insight, Bloomberg

The U.S. uses the loan syndication process more than any other country in the world. In the first three quarters of 2012, there were more than 2,100 syndications in the U.S. alone. The average loan size was $463.3 million and the total volume of loans was $994.9 billion. The largest U.S. bank, JPMorgan Chase, was the top arranger with 642 loans and $173.2 billion of loan volume. The combined countries of Europe saw the next closest amount of syndicated loans, with a total volume of

[13] Aspan, "Are Giant Banks Indispensable? No, Says Big Business," American Banker, August 21, 2012..
[14] "2012 Global Syndicated Loans League Tables," Bloomberg, September 29, 2012.

$363.6 billion – a little more than half the amount of the U.S. Other countries throughout the world use the process less.

Some may argue that a loan of this magnitude is rare and is therefore a coincidental example of the lending roles of large U.S. and foreign players. The data reveals that this isn't the case. The reason for going with a syndication is because the loan's size warrants diversification. Syndicated loans allow multiple underwriters to participate while spreading the risks associated with lending.

The second largest syndication this year, a loan of over $11 billion to energy giant Kinder Morgan, received its underwriting from 10 global banks. The same U.S. banks, the largest four, took part in the underwriting process, while the remaining six were large foreign banks from all over the globe, including banks from Canada, Germany, Japan, the U.K., and Switzerland. In fact, when looking down the list of the largest U.S. syndications for 2012, the same global banks show up on the list, proving that multinational companies require large banks to fill financing needs.

"U.S. companies require large banks to fill financing needs."

The Market Prefers To Have Large Banks Finance Large Funding Needs

If U.S. banks were broken up, their size reduced, and financing activities limited, what choices would large multinational companies then have to access crucial funding?

The first option would be to have significantly more U.S. banks, albeit smaller ones, underwrite loans. How many? Basic math shows that if you took the largest four U.S. banks and cut their size down to $300 billion in assets (there are only 10 U.S. banks larger than $300 billion and more than 6,700 with less as of the most recent data), they would have enough assets to create 25 smaller banks. This does not calculate the necessary investment banking services.

"In the U.S. syndicated loan market alone, large European banks have greater market share than U.S. regional. Not one regional bank cracks the top 10."

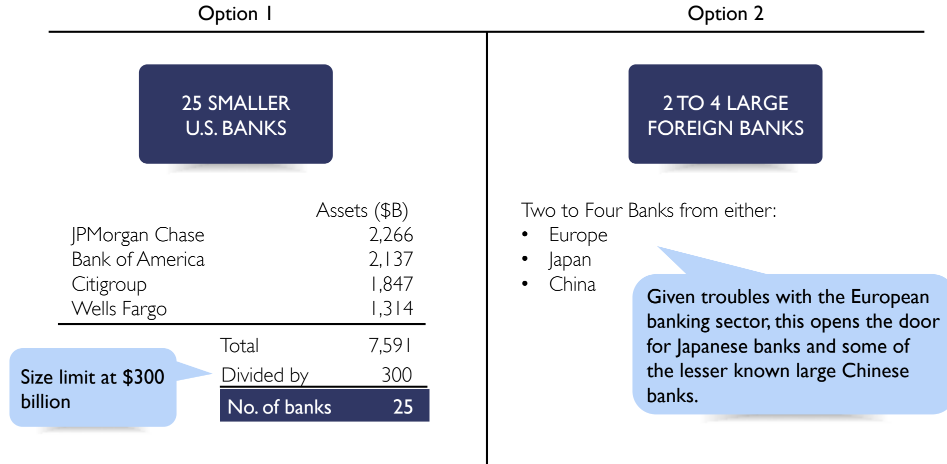
Now, if size and services are a determinate of which banks are chosen for the syndicate process (they are); and foreign banks are still of similar size, if not larger than the biggest U.S. banks; and they offer a wider array of services, why would a multinational company choose the significantly more complex underwriting option? We know that complexity increases costs; therefore, borrowers will shun this

option and choose the latter, using the services of large foreign banks rather than trying to coordinate a larger number of smaller U.S. banks (Exhibit 7).

Exhibit 7

IF U.S. BANKS ARE BROKEN UP, FOREIGN BANKS WOULD DOMINATE SYNDICATED LOAN MARKET

Options for borrowers if U.S. banks are broken-up and size is capped at $300 billion*

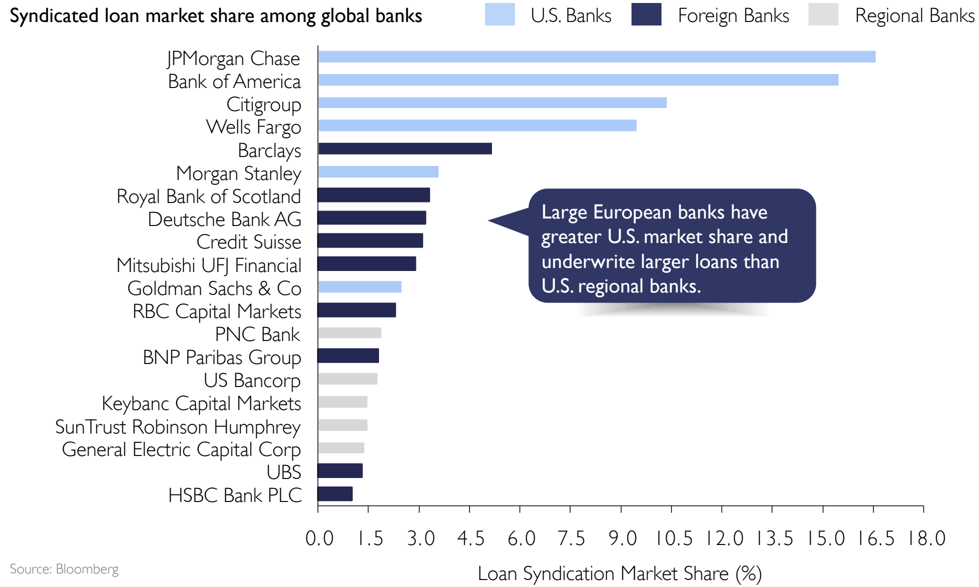


Source: HPS Insight, Milken Institute, Federal Reserve, BankScope, Bloomberg
*There are 10 top-tier U.S. banks with assets in excess of $300 billion, and 6,701 with less .

Not one U.S. regional bank cracks the top 10 in a ranking of U.S. loan syndications (Exhibit 8). Meanwhile, European banks such as Barclay's, Deutsche Bank, and Credit Suisse are in prime positions to gain market share. Notably, there are U.S. regional banks in the top 20, and market consolidation might allow these mid-size banks to grow and enter the global competitive arena in the future, if regulation does not constrain them from doing so. Yet, many regional banks also breach some too-big-to-fail asset thresholds, and their already medium-sized operations would shrink under most proposed break-up proposals.

Exhibit 8

NO U.S. REGIONAL BANK IS IN THE TOP 10 IN THE U.S. LOAN SYNDICATION MARKET



Source: Bloomberg

In The Short Run, European And Japanese Banks Will Fund Large Investments

U.S. syndicated loan data and other capital markets rankings indicate that small banks are not a substitute for large banks, and thus a breakup of the largest U.S. banks would place the U.S. banking sector at a significant disadvantage relative to large foreign banks.

Which institutions would fill the gap?

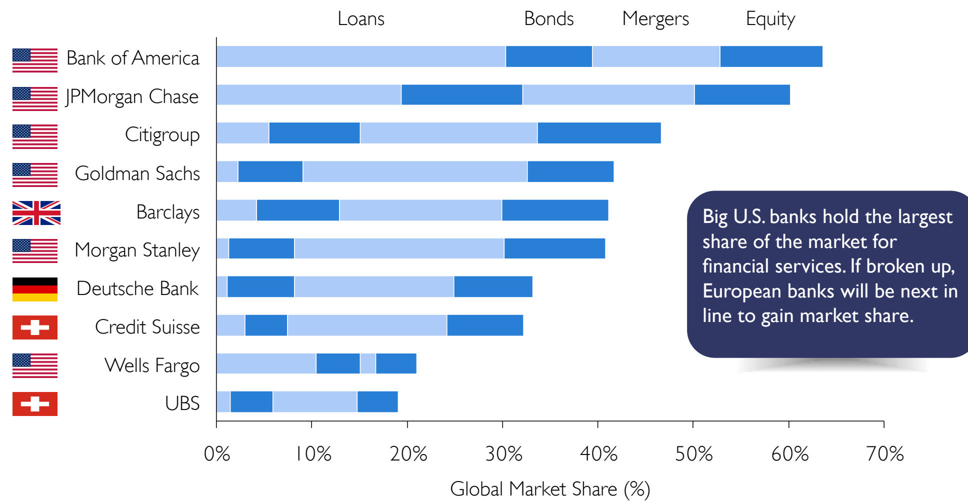
In the short-term, it is likely that foreign banks already with a global presence would be the first to meet the needs of global companies. In the long-term, it is likely that the institutions that have made significant inroads with large companies and have the largest potential for growth are going to replace U.S. banks in the event of a break-up. One needs only to look at a finite set of institutions to see what the future holds (Exhibit 9).

"In the long-term, it is likely that the institutions that have made significant inroads with large companies and have the largest potential for growth are going to replace U.S. banks in the event of their break-up."

Exhibit 9

BIG U.S. AND EUROPEAN BANKS PROVIDE HALF OF GLOBAL INVESTMENT BANKING NEEDS

Investment banking market share in 2012 by underwriting activity



Source: Bloomberg

Currently, the largest foreign banks with a U.S. presence are from Europe, Canada, Japan, and China.

Canadian banks hold U.S. assets of $654 billion, while on the opposite end of the spectrum, Chinese banks hold U.S. assets of $63.8 billion. However, Chinese banks are relatively new to the U.S. financial sector and growing - in 2005, they owned just $4.4 billion of U.S. banking assets.[15]

In The Long Run, Financial Institutions That Continue To Exhibit Growth Will Be The Next Global Leaders

> "China now holds the highest share of bank assets in the world as of the end of 2012…"

As shown earlier in Exhibit 5, China's economy represents the second highest share of the world's GDP, directly behind the U.S. This is likely to change. The IMF predicts that China's GDP will surpass America's in 2016 if measured on a purchasing-power-parity (PPP) basis. *The Economist* magazine predicts that in dollar terms, China will overtake the U.S. by

[15] Alloway and Braithwaite, "TD Looks to Fill the Gap in U.S. Banking," The Financial Times, July 22, 2012.

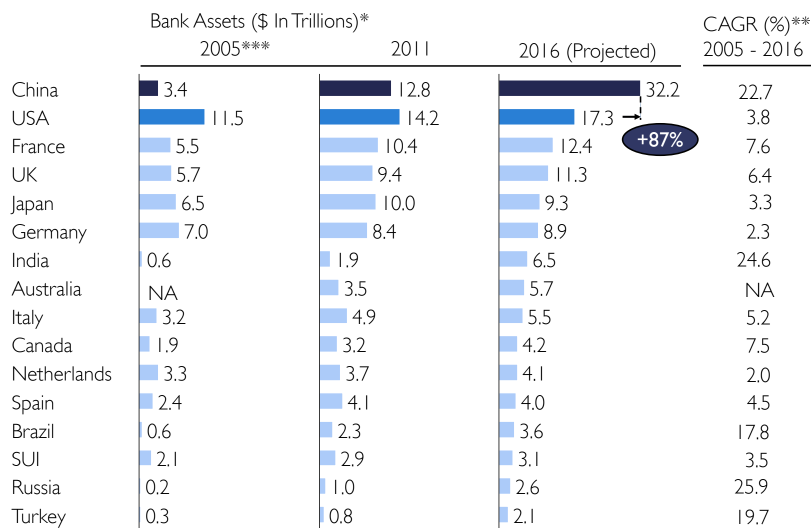
2018, based on a specific set of assumptions. Regardless of whether these assumptions hold, the probability is still high that China will overtake U.S. GDP in the coming years.[16]

China now holds the highest share of bank assets in the world as of the end of 2012, according to estimates.[17] More striking is the rate at which China's bank assets are increasing. According to data provided by the Economist Intelligence Unit, the research division of *The Economist* magazine, China's bank assets will continue to grow at a compounded annual rate of 22.7 percent through 2016. Estimates show that the U.S. will grow at just 3.8 percent over the same period. Based on a straight-line growth rate, Chinese bank assets should have overtaken those in the U.S. in September of 2012. By 2016, China's bank assets are projected to increase to $32.2 trillion, 87 percent larger than those of U.S. banks (Exhibit 10).[18]

Exhibit 10

EUROPEAN, CHINESE, AND CANADIAN BANKING SECTORS ARE GROWING FASTER THAN THE U.S. SECTOR

Countries with largest bank assets by 2016



*Total assets of the banking system. Includes cash and balance with the central bank, interbank deposits, loans, securities and other assets.
**Compound Annual Growth Rate
***2005 is the first year the EIU reports data, while 2011 is the current year and 2016 is the furthest projected year.

Another widely used indicator that designates confidence in the future growth opportunities of a company is its market capitalization. The investment community uses this figure to determine a company's size, as opposed to total asset figures as shown in Exhibit 1. Since the value of a company is determined by elements of its discounted future cash flow, i.e. its earnings potential, plus other factors both fundamental and intangible, this metric should also point to which banks are most likely to fill the gap left by a break-up of U.S. banks over the long-term.

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[16] "How To Get a Date: The Year when the Chinese Economy Will Truly Eclipse America's is in Sight," The Economist, December 31, 2011.
[17] SNL Financial, HPSInsight, this includes cash and balances with the central bank, interbank deposits, loans, securities and other assets
[18] Projections provided by the Economist Intelligence Unit, a division of the Economist 2012.

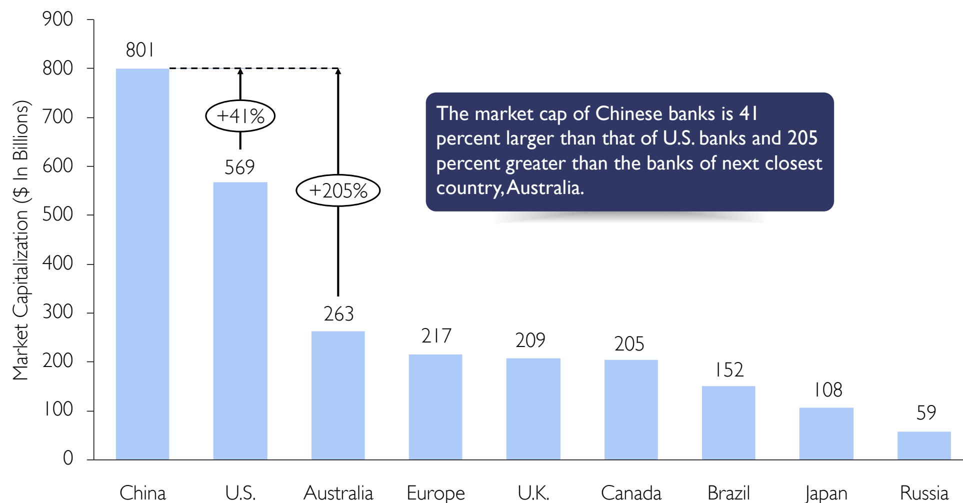
Which global banks rank at the top of the market capitalization list?

Two Chinese banks, the Industrial & Commercial Bank of China (ICBC) and China Construction Bank, lead the market. In fact, the "big four" Chinese banks, also including the Agriculture Bank of China and Bank of China, rank in the world's top 10 largest banks by market capitalization as of the end of 2011. Collectively, Chinese banks outperform U.S. banks by 41 percent or $232 billion in terms of market capitalization (Exhibit 11).[19]

Exhibit 11

THE CHINESE BANKING SECTOR IS EXPECTED TO OUTPERFORM ALL OTHERS

Market capitalization of the world's largest banks



Source: HPS Insight, BanksDaily.com

Shadow Banks Will Also Benefit From A Bank Breakup

Shadow banks are more difficult to define than the heavily regulated and charter-oriented traditional banks. Deloitte's Shadow Banking Index attempts to label the types of companies and activities that make up this industry, but notes "there have been disparate characterizations of what the shadow banking sector truly entails."

Estimates size the sector anywhere from $10 to $60 trillion at the end of 2011. The sector saw its largest growth from 2004 to 2008, at the time surpassing the size of the traditional banking sector. It has since seen an "abrupt decline" due to the financial crisis. Deloitte values the sector at $9.53 trillion - 25 percent smaller than it was in 2004.[20] The Financial Stability Board's estimates the sectors size at $20

[19] "The World's 30 Largest Banks By Market Capitalization: Chinese Bank ICBC is the Largest Bank in the World," BankDaily.com, 2011.
[20] Kocjan, Ogilvie, Schneider and Srinivas, "The Deloitte Shadow Banking Index: Shedding Light on Banking's Shadows," 2012.

trillion.[21] The inclusion or exclusion of certain nonbank financial entities can heavily influence these estimates.

The shadow banking sector has an economic role similar to the credit intermediation role of traditional banks, however, instead of taking deposits and making loans under "one roof", shadow banking is more complex.

According to the Federal Reserve of New York, "The shadow banking system decomposes the simple process of deposit-funded, hold-to-maturity lending conducted by banks into a more complex, wholesale-funded, securitization-based lending process."[22]

This more complex process spreads the risk of an investment, and thereby lowers the cost of doing business. However, it should be noted that the shadow banking sector does not have the regulations and institutions in place that are common to the traditional banking sector, thus access to funding is limited to the largest companies, which can be troubling in times of crisis.

"The benefits of prohibiting banks from engaging in high-risk activities…would be limited if those activities continue to threaten stability by mostly migrating to the 'shadow' banking system."

Bank break-up proponents have concerns about the flow of activities to shadow banking. In his paper, *Restructuring the Banking System to Improve Safety and Soundness*[23], Thomas Hoenig states that the benefits of breaking up U.S. banks would be limited "if those activities continue to threaten stability by mostly migrating to the 'shadow' banking system."

Many of the emergency funding initiatives of the recent crisis were designed to backstop the entire financial system, not just traditional banking. The Troubled Asset Relief Program (TARP), initially designed for traditional banks, was eventually opened to many nonbanks.

Other emergency actions were specifically designed for the shadow banking sector. For example, Money Market Mutual Funds (MMMFs) experienced a considerable liquidity crunch during the crisis. MMMFs are important to the economy in that they are viewed as a low-cost, high return substitute to deposits. Realizing the damage the reduction in liquidity was causing, the Federal Reserve responded with the Primary Dealer Credit Facility (PDCF). This was done in order to cover tri-party repo markets, which MMMFs and other fund rely on. Additionally, the FDIC

[21] "Shadow Banking: Strengthening Oversight and Regulation," Financial Stability Board, October 2011.
[22] Adrian, Ashcraft, Boesky and Pozsar, "Shadow Banking," Federal Reserve Bank of New York, Staff Reports, February 2012.
[23] Hoenig, "Restructuring the Banking System to Improve Safety and Soundness," Federal Reserve Bank of Kansas City, May 2011.

implemented the Temporary Liquidity Guarantee Program (TLGP), which backstopped senior unsecured bank debt, and for a period, the U.S. Treasury temporarily guaranteed all MMMFs.

Another area where traditional banks compete with nonbank institutions is the commercial paper market. Commercial paper has grown to be an alternative to large short-term loans, and has been a boon for specialty lenders over the past decade. Similar to MMMFs during the crisis, the commercial paper market also experienced a crisis of liquidity. In order to promote stability, the Federal Reserve designed the Commercial Paper Funding Facility (CPFF) to backstop U.S. issuers of commercial paper, and thus improved liquidity and provided greater availability of credit for businesses and households.

"Emergency funding for shadow banks during the crisis were modern day equivalents to FDIC deposit insurance."

In summary, these programs were temporary equivalents to modern-day deposit insurance for traditional banks and, according to the Federal Reserve, implementation of these programs during the financial crisis was "an explicit recognition of the need to channel emergency funds into [shadow banks]."[24]

Gary Gorton, professor at Yale, has written extensively on the cause of the recent crisis and the rise and importance of the shadow banking system in the U.S. over the past several years. He states that both traditional banks and the shadow or "parallel" system is "a genuine banking system," and that it is critical to the economy. "Investors and non-financial firms have a need for short-term, safe, interest-earning, transaction accounts like demand deposits: repo," he continues, and "there is nothing mysterious or irrational about the [financial] panic."

The economy has expressed a need for new debt instruments over the past several decades, though much like the bank-runs on demand deposits in the early 20th century, these new financial liabilities are also vulnerable, as shown with the necessary guarantees made by the federal government during the crisis.

In its study, Deloitte concluded that "…new shadow banking activities will emerge in the future. Such innovations in regulatory arbitrage may once again result in some explosive growth, possibly posing increased systemic risk to the financial system."[25] A break-up of the banks will most likely accelerate this process.

[24] Adrian, Ashcraft, Boesky and Pozsar, "Shadow Banking," Federal Reserve Bank of New York, Staff Reports, February 2012.
[25] Kocjan, Ogilvie, Schneider and Srinivas, "The Deloitte Shadow Banking Index: Shedding Light on Banking's Shadows," 2012.

Conclusion

In an economy with global needs, large banks provide services that go beyond traditional banking activities. When individuals and businesses deposit funds with banks today, they not only help their neighbors build homes to live in, they also help fuel the growth of American companies at home and abroad.

Small banks, large banks, and nonbank financial institutions, both at home and abroad, provide multiple services that make complex credit intermediation simple.

This is the ongoing evolution of the economy and banking sector we have seen. Managing toward the future requires forward-looking policies. There is simply no way to return to the era of George Bailey, even if we wanted to.

About Hamilton Place Strategies

This report was prepared by Patrick Sims, Director at Hamilton Place Strategies. Prior to joining HPS, Patrick acted as the lead research analyst in the financial institutions' group at SNL Financial and worked for the CFA Institute.

Hamilton Place Strategies is a policy and communications consulting firm based in Washington. As a firm, our focus and expertise lie at the intersection of government, business and media. Our deep experiences on all of these dimensions allow us to serve industry leaders seeking to navigate the paths between Washington and the private sector.

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