# The Problem of Big Business

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THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

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# Motivation: alarm over increasing business size & market concentration

- **Financial sector**
  - Bank size & concentration have risen dramatically; same high levels in China
  - Less regulated non-banks and asset managers have grown rapidly post GFC
- **"Bigtech"** (large technology firms): market share in not one but many sectors has skyrocketed as "winner takes all"
- **Finance and Bigtech are now merging** making the size problem really urgent
- **Policy makers are at loss on how to regulate** (or if they want to regulate…)
- **Holistic approach is needed** to re-assess the pros & cons of economic size *across* sectors and to take account of political economy considerations

# Something does not fit …

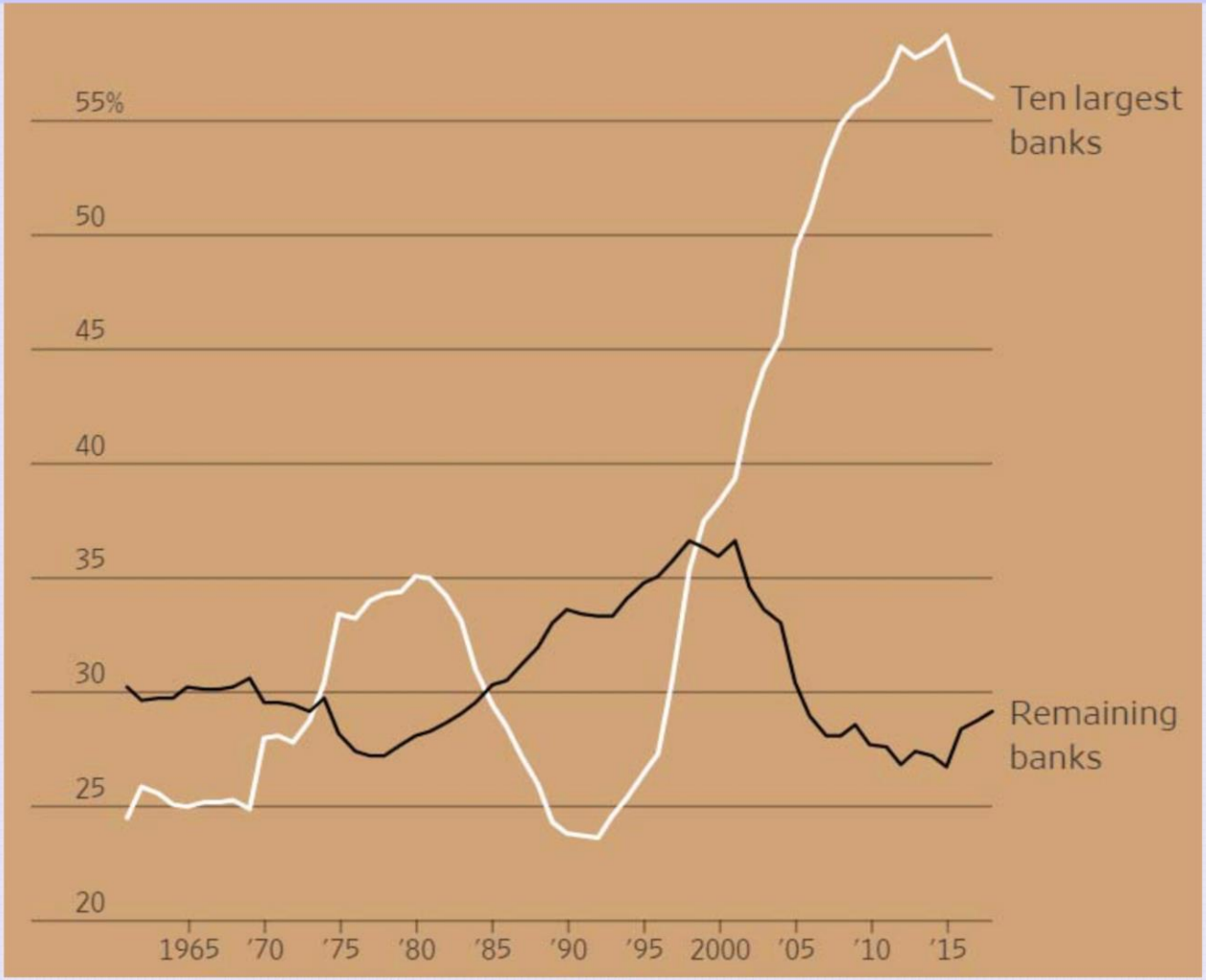
# Outline

- Banks (primary focus) and non-banks & asset managers
- Bigtech
- Bigtech moving into finance
- Policy issues and options
- Conclusion

# Issue of size

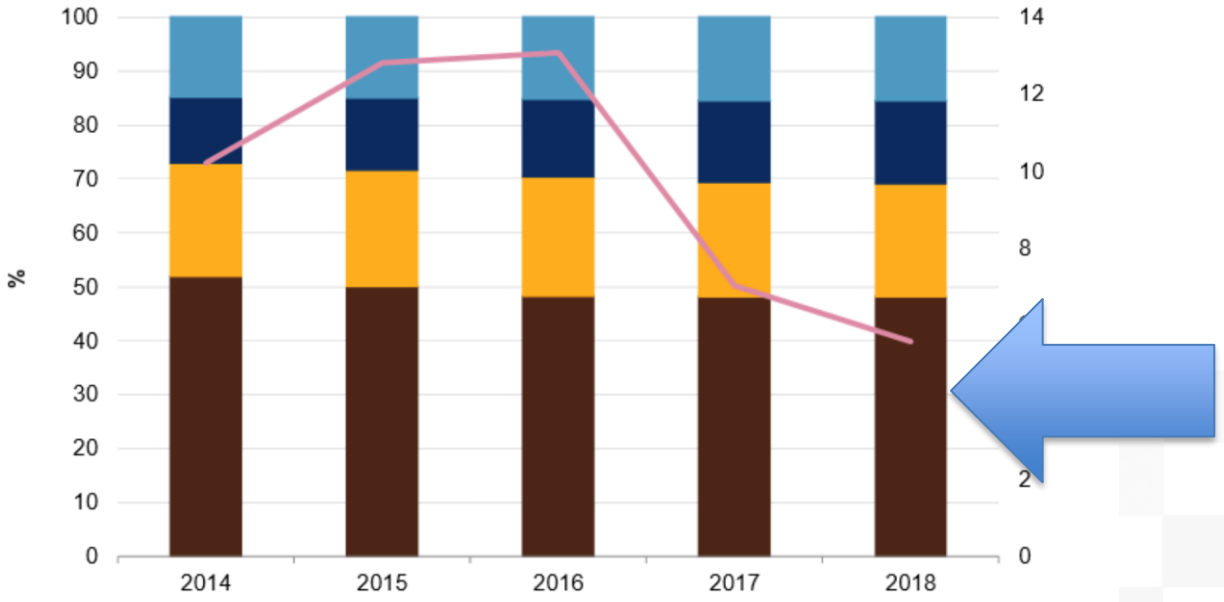
# 1: Banks

# Greater Bank Concentration



# In China: 5 largest banks also hold 50% banking assets

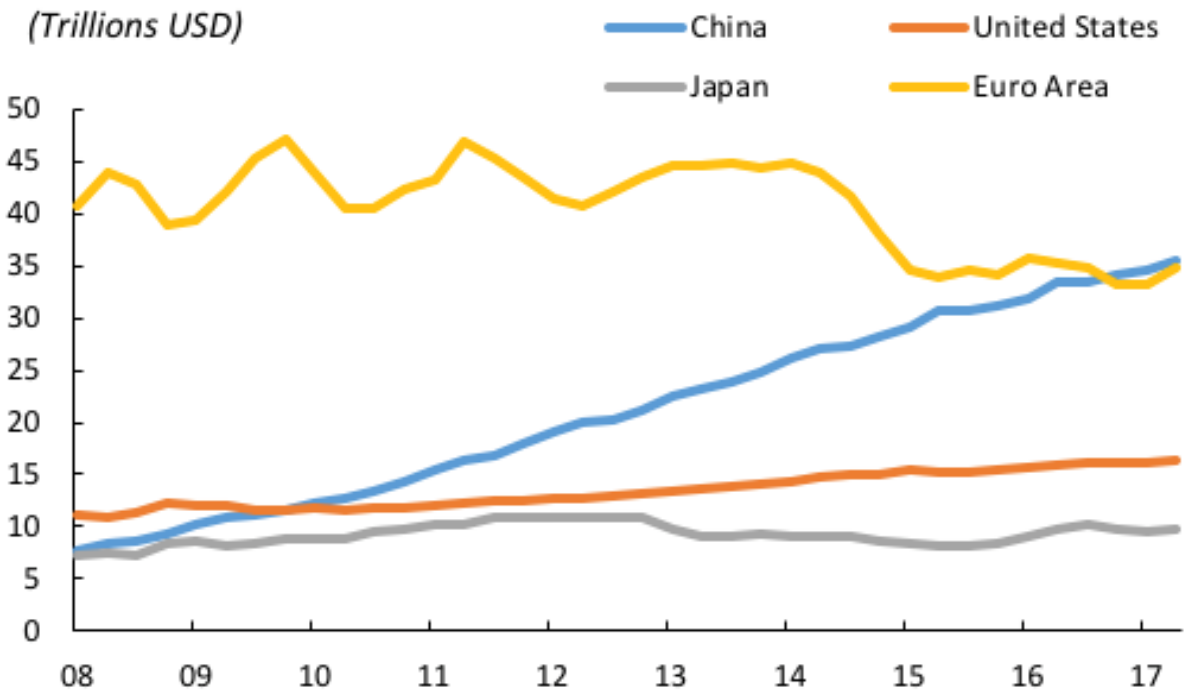
**Megabanks Dominate The Market Structure**
Assets as a percentage of all commercial banking assets




Note: This excludes policy banks, private banks and foreign banks' China subsidiaries. The China Banking and Insurance Regulatory Commission (CBIRC) did not report separate data for rural commercial banks for 2013. YoY--year on year. Source: CBIRC, Postal Savings Bank of China annual reports, S&P Global Ratings.


*Source: BIS Annual Report 2019*

# And China's banking sector is now the largest in the world




*Sources: Cerutti & Zhou: The Chinese banking system, VoxEU, February 2018; BIS, ECB, IMF*

# Pros & cons of big banks

**Benefits of larger size**

- Economies of scale and scope: better efficiency, more credit, growth, and employment
  - Is this true? New LSE research
- Cross-border banks serve cross-border business

**Problems of larger size**

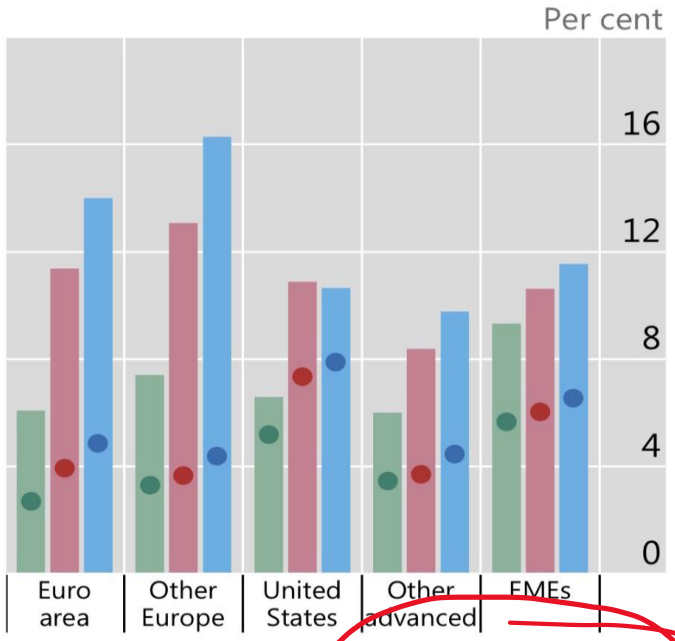
- **When they fail, the crisis is devastating – societies still paying the price of 2008 GFS**
- Market dominance/monopolistic behaviour
- Global banks must have global funding LTOR such as CB currency swaps. Yet these are not regularised

# Banking: significant post GSF regulatory reform

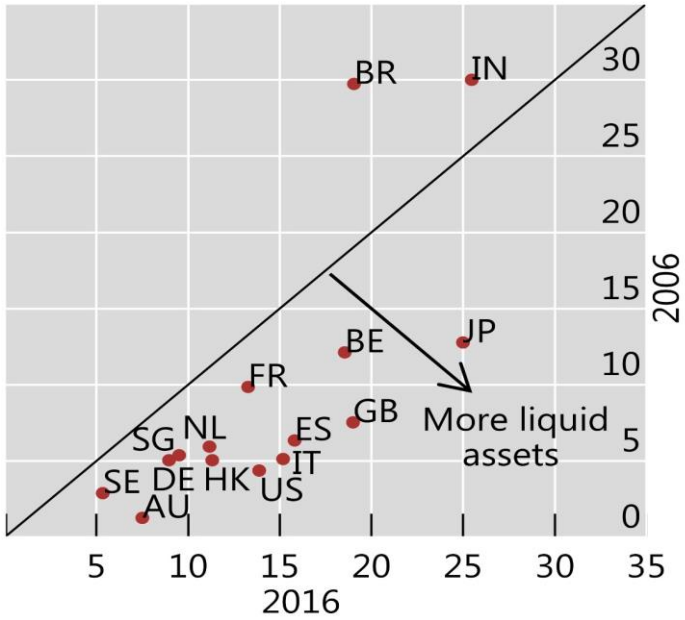
- **Micro-prudential**
  - Better quality and more quantity of capital
  - Limiting  leverage ratio (LR)
  - Better liquidity (LCR)
  - Better funding structures: net stable funding ratio (NSFR)
  - Functioning resolution mechanism/Total loss absorbing capacity (TLAC) targets
- **Macro-prudential**
  - Countercyclical cap buffer
  - Size distinction introduced G-SIBs (or broader G-SIFIs); D-SIBs capital req
  - Lending standards (LTV, LTI etc)
- **Other**: restriction on business model (Volker rule, Vickers Commission); pay limits, governance…

# Banks are better capitalised and much more liquid

Bank capital ratios[1, 2]

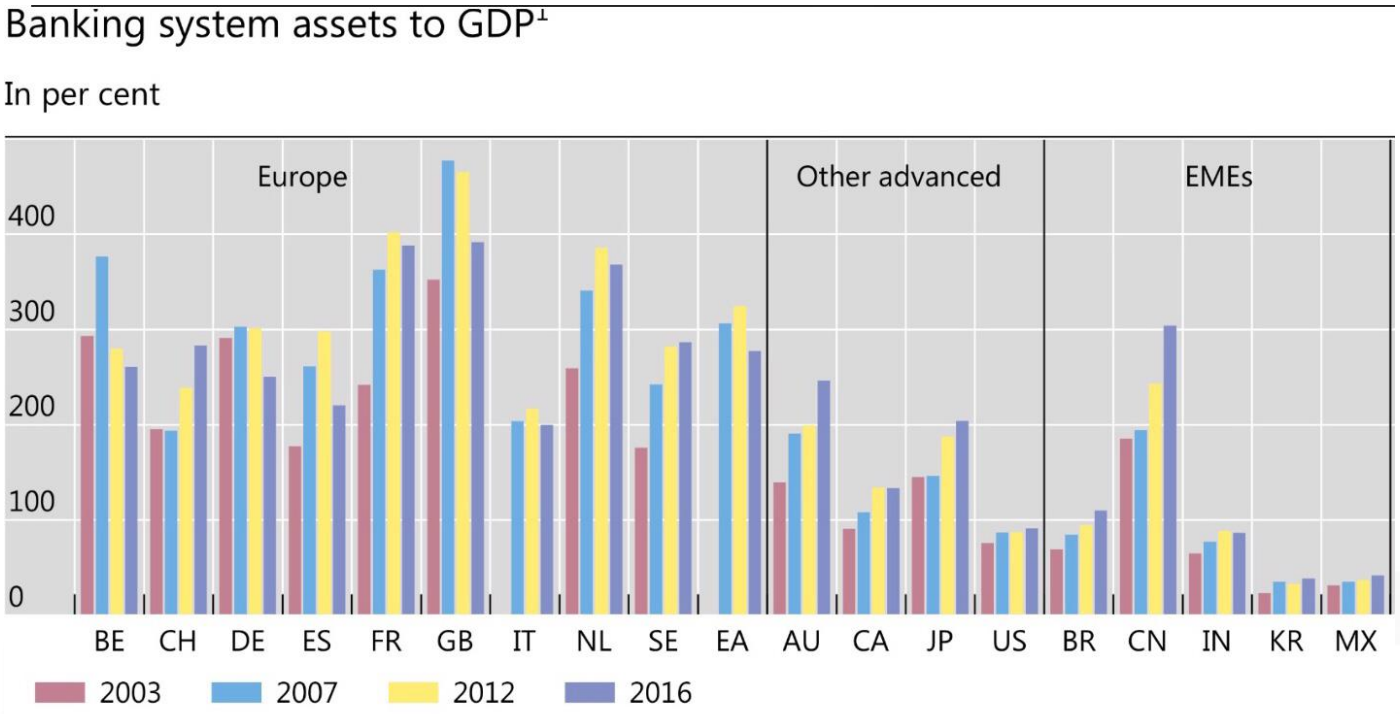



Share of liquid assets in total assets, in per cent[1]




*Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018*

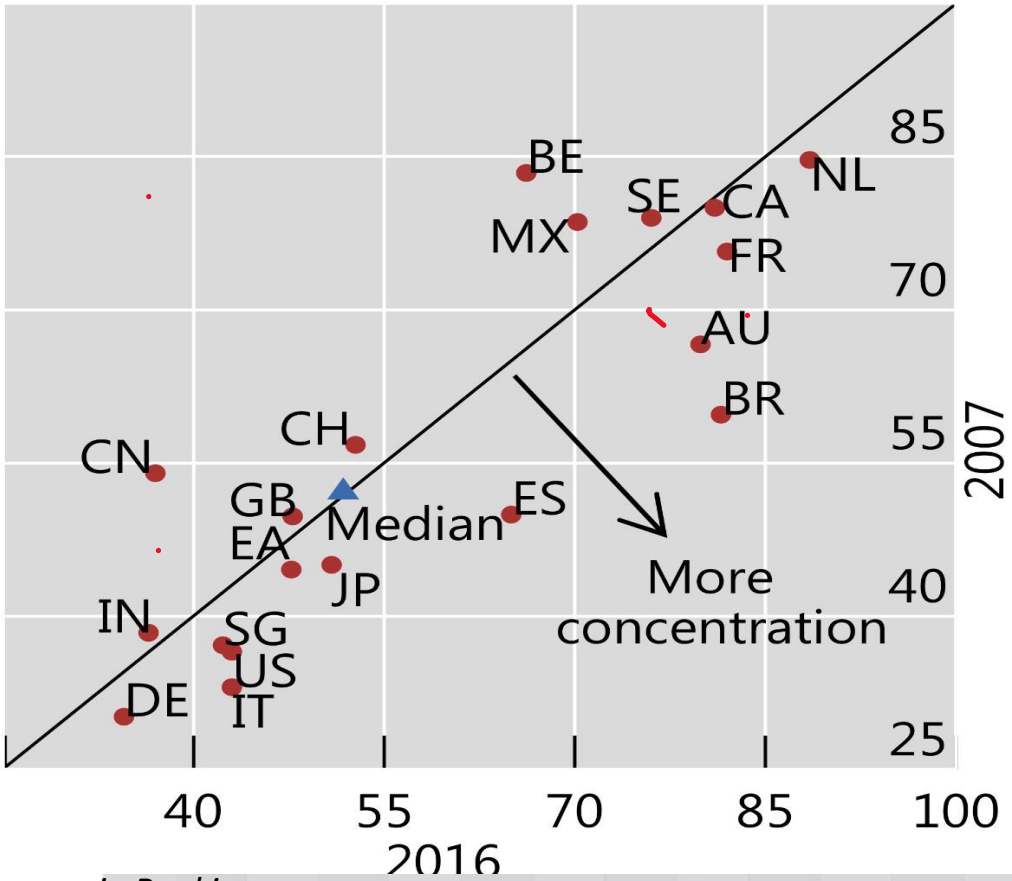
# Containing bank balance sheets – except for China




*Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018*

# But banking sector concentration has generally increased

Banking system concentration, share of system assets of 5 largest banks[3]




*Source: Structural Changes in Banking after the Crisis, BIS CGFS January 2018*

# And serious issues persist

- **Too much regulation?**
  - Multiple problem – multiple instruments
  - Compliance issue for small bank & entry
  - Maybe also ”MacroConduct” not only ”MacroPru” because of short-termism leads to risky behaviour. Only credit boom with “flash” ST strategies create crisis (Kevin James et al 2017)
- **Is regulatory capital sufficient?**
  - “Optimal”: Tier 1 ~ 16-19% - Today 2/3 of G-SIBs and D-SIBs have less
  - Does higher capital result in less lending? Good news: No (Cecchetti 2014); Positive for lending and lowering risk premium (Hyun Son Shin 2017)
  - Trade-off: capital – credible resolution mechanism TLAC (Holdane 2017)
- **Is the Too-Big-To-Fail problem solved?**
  - NO! (my view)
- **And the political economy of central banks is getting murkier by the day**
  - CBs are deep in political territory; joint tasks with fiscal authority
  - Central bankers are primary target of anti-elite populism

# But is “bigger more efficient”? Evidence from post WW2 West Germany

- Post WW2 in 1947 Allied Forces broke up the 3 largest German banks for financing the Hitler regime (Deutsche, Dresden and Commerzbank) into 30 state banks
- Subsequently gradual reunification were allowed: in 1952 into 9 larger units; then in 1957 all restrictions were lifted and the 3 large systemic banks recreated (as W Germany regained sovereignty)
- Kilian Hubert/LSE studied this natural experiment asking whether reunified large banks were better for growth and efficiency (2017)

# Research results: no good economic impact but more political influence

- Increased bank size after the 1957 reunification did not increase cost efficiency or lending to clients —> no efficiency gains or positive impact on the real economy
- No positive employment impact
- But media presence jumped, with more lobby power for the large banks —> increased empire building despite no efficiency gains and **more political influence**
- This questions arguments against regulation of bank size (positive relationships between bank size, bank efficiency and growth)

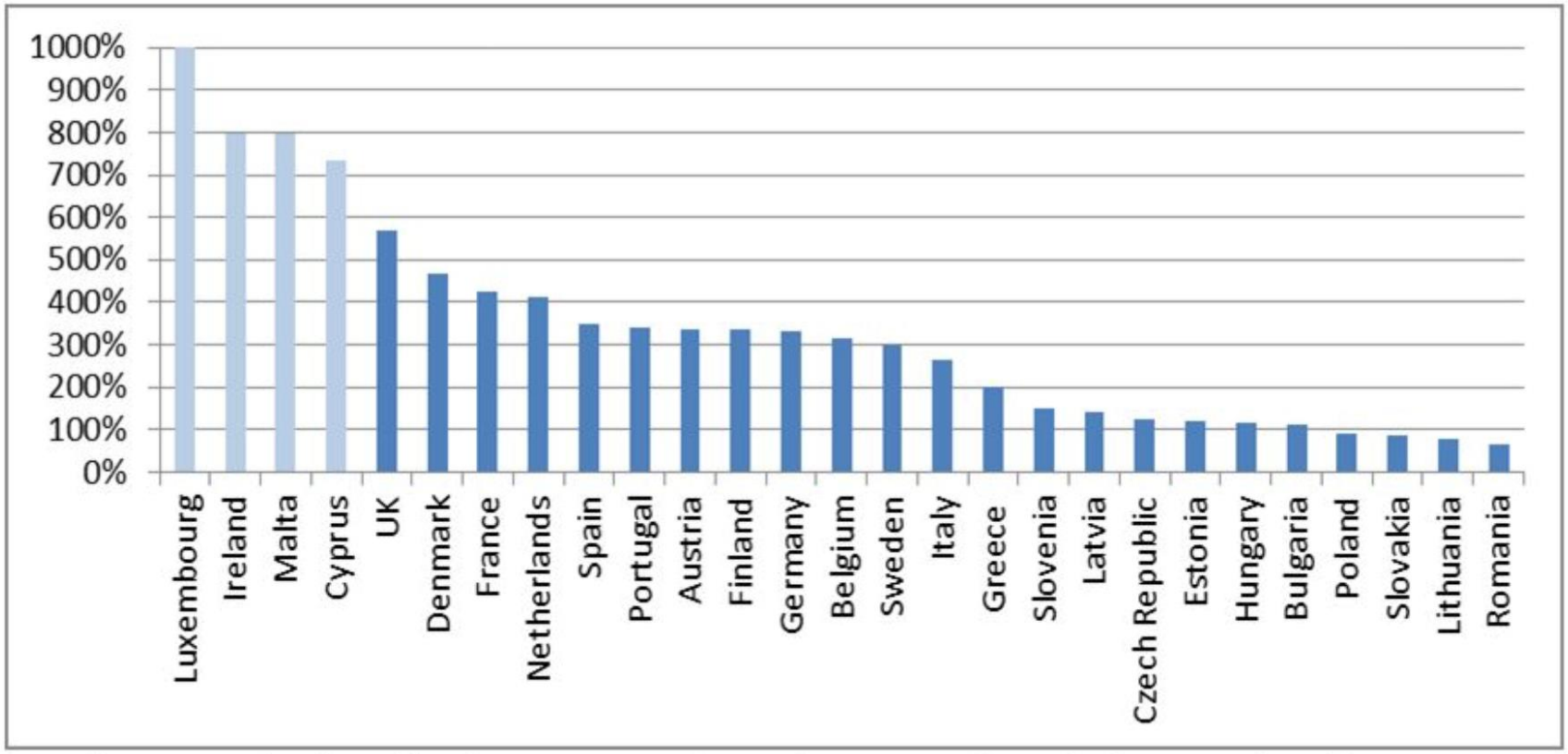
# Two types of problems

- **Too-Big-To-Fail (TBTF)**

  or

- **Too-Big-To-Save (TBTS)**

# Banking systems are big relative to country size (%)GDP……



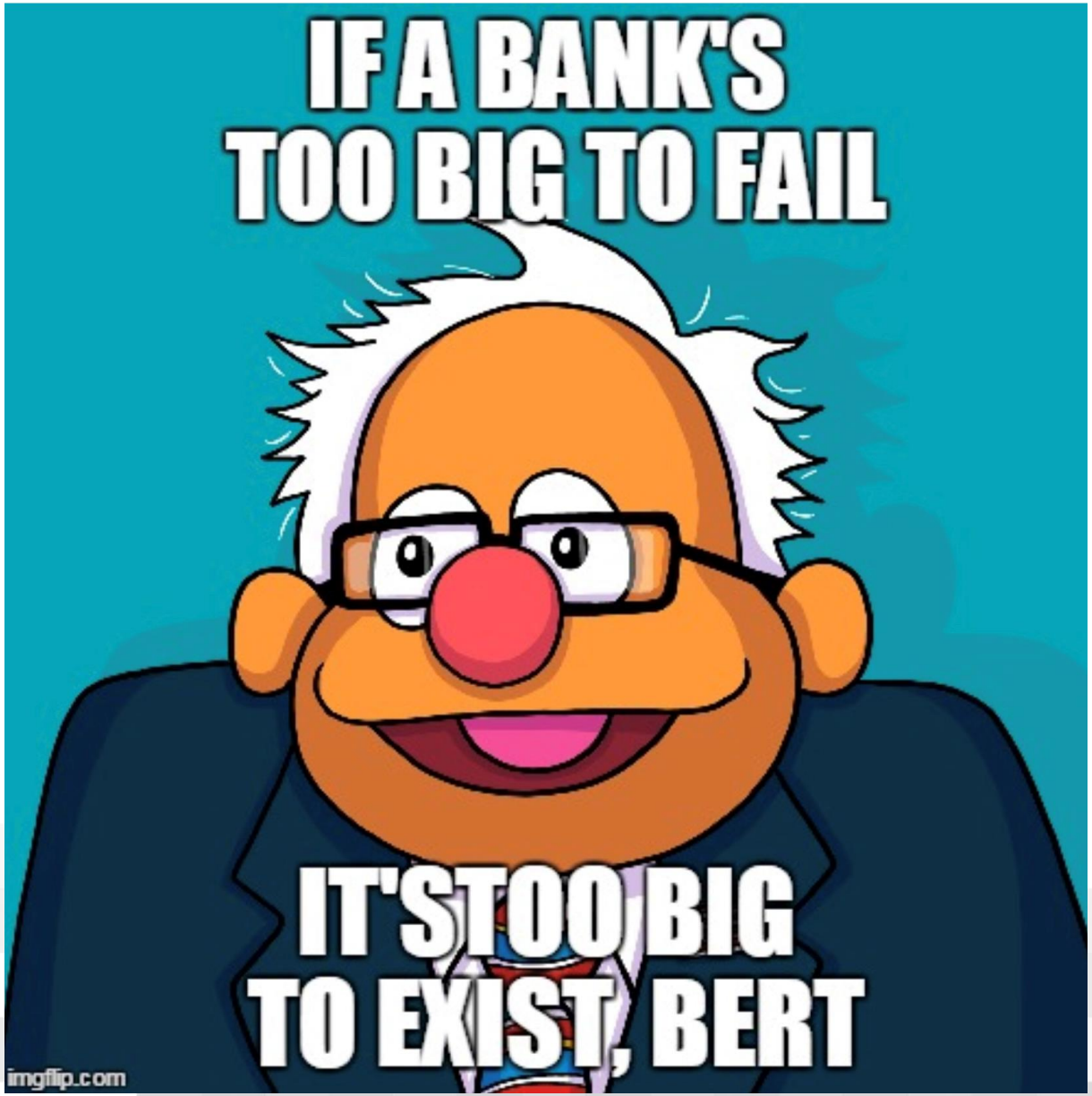

Source: Liikanen Report (2012) High-level Expert Group on reforming the structure of the EU banking sector Chaired by Erkki Liikanen, FINAL REPORT Brussels, 2 October 2012 , p

# So should we regulate bank size ?

- It could be very complicated: which one; how; cost/benefit analysis
- Would simply more of the same regulation for larger banks be a solution?
  - Hard: SIFI status (FSB/BIS classification of systemically important banks with more stringent regulation) is very unpopular
  - Several SIFI are taking steps to be removed from the list (GE capital, CIT, AIG, Prudential, MetLife…)
- **But** the cost of <u>not</u> regulating bank size loom large

# There are options in banking to regulate excessive size

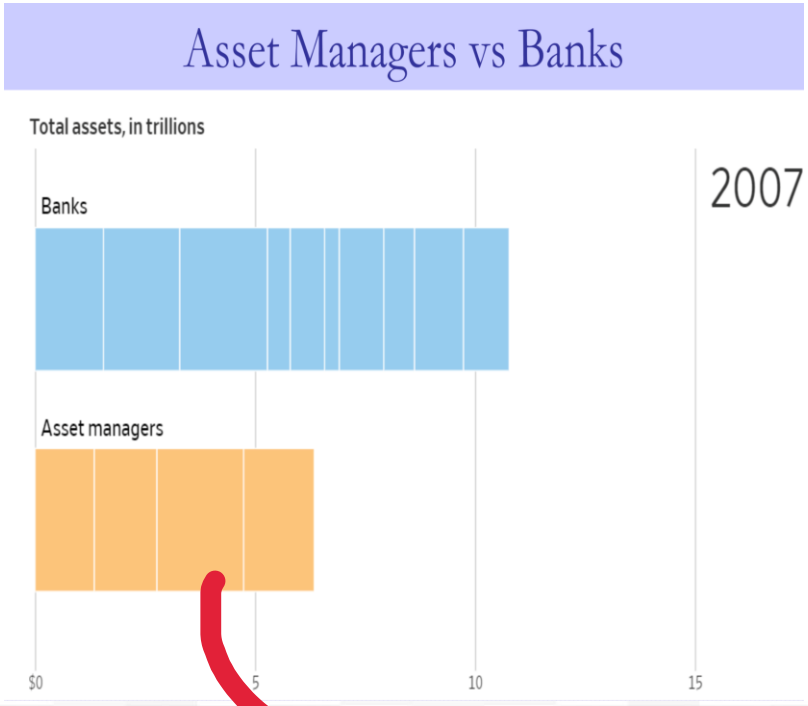
1) **Stronger size-based capital** (many academics agree)**:** more clear regulatory distinction between SIFIs and small & medium size banks: SIFIs should have event more capital, but SM banks should be less regulated
2) **Fiscal capacity-based capital** for TBTS problems (Vania Stavrakeva, LBS)
    - Bail-out/fiscal capacity is different among countries but regulation is harmonised
3) **Ring-fencing** household related portfolio (UK)
4) **Breaking up excessive sized banks** is part of Dodd-Frank regulation (2010) for “grave systemic risks” & proposed by Governor of the Minneapolis Fed in 2016
5) **Antitrust laws – use them**! Tarullo (2012): do pre-merger reviews with *presumption of denial* for very large banks
6) **Use digital innovation: central bank digital currency** to control/reduce bank size in a planned manner and also moral hazard (DI) (my idea)


IF A BANK'S
TOO BIG TO FAIL
IT'S TOO BIG
TO EXIST, BERT
imgflip.com

# At the same time non-banks are getting bigger and bigger

- *Non-bank* finance has exploded post GFS as it is less regulated than banks due to supposedly less systemically important
  - Not sure… Bank of England stress testing these units focussing not on capital but liquidity adequacy
  - Asset management, which now oversees more financial assets than do banks in advanced economies, is lightly regulated…

# Global rise of asset managers
# BlackRock, State Street, PIMCO, Mellon…

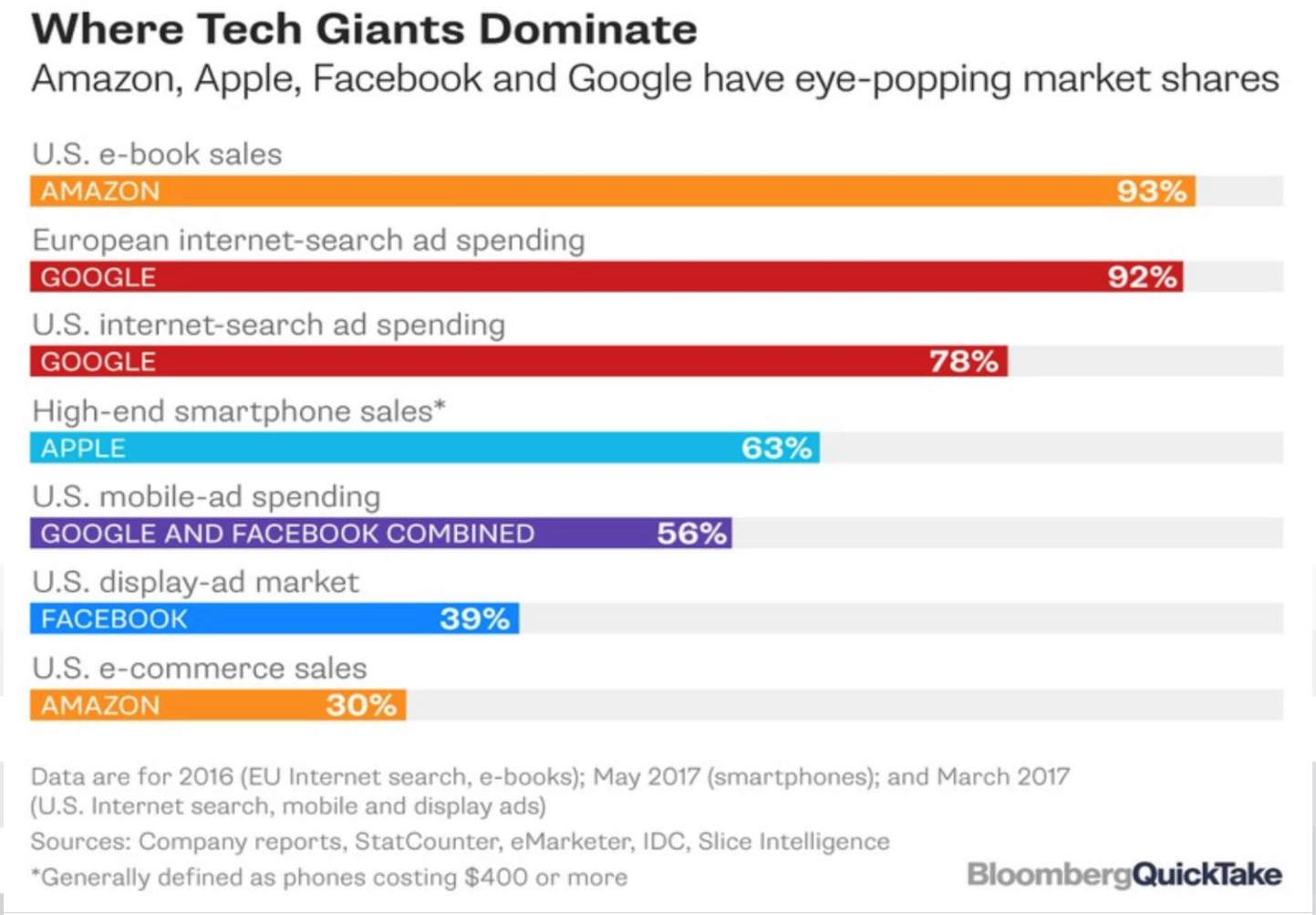



# Issue of size

# 2: Bigtech

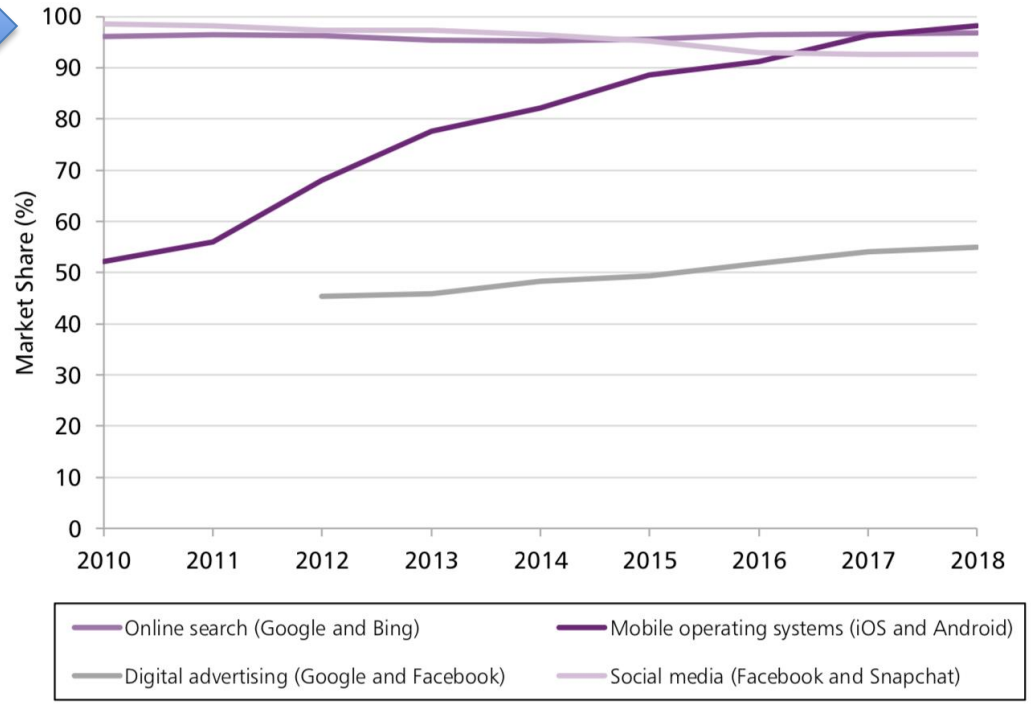
# Bigtech

GAFA: Google, Apple, Facebook, and Amazon:
the 4 most powerful American technology companies



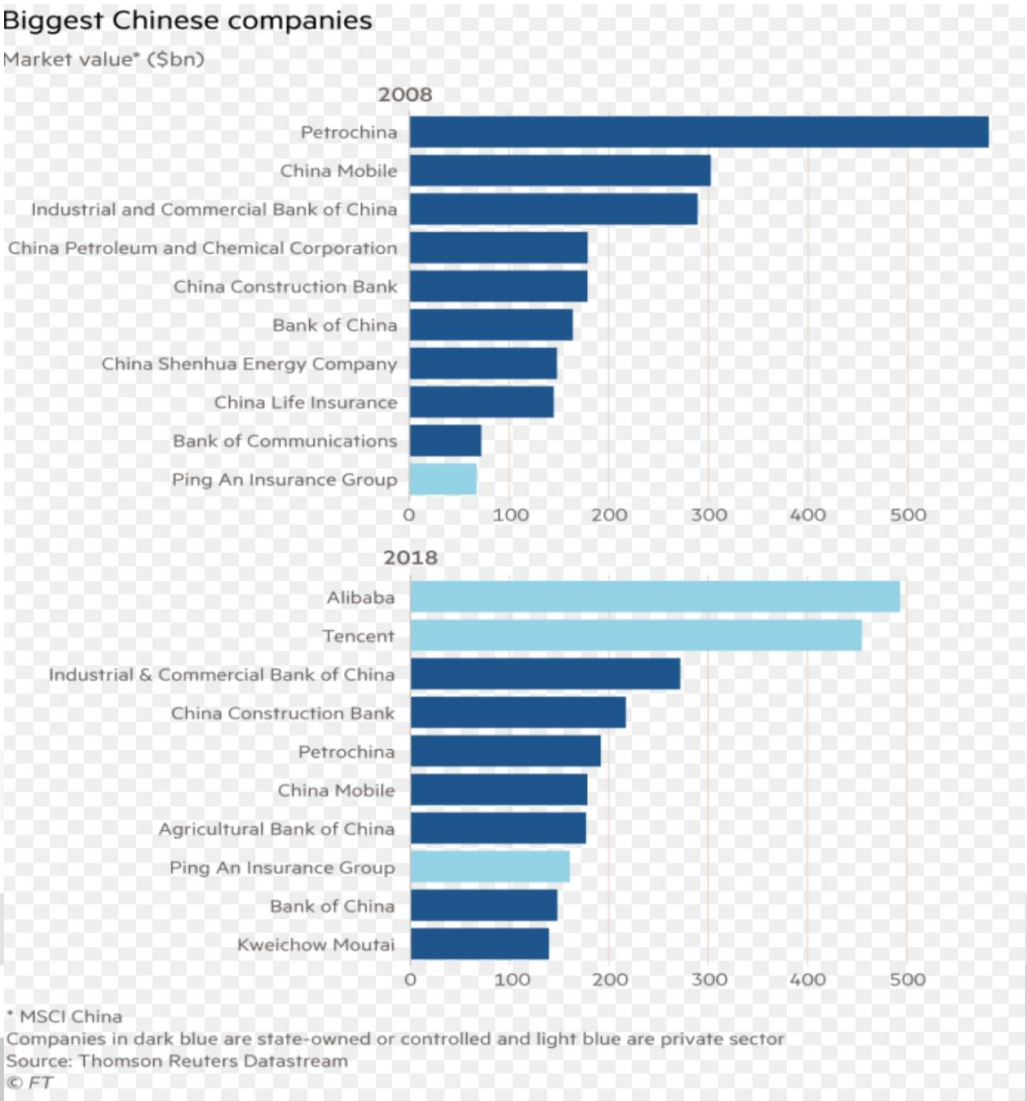
# The staggering dominance of 1-2 players in the UK digital markets

Chart 1.B: Combined indicative market shares of current leading two companies in selected UK digital markets




*Sources: StatCounter,[21] Comscore,[22] and eMarketer and company reports[23]*

# China's Bigtech (Alibaba, Tencent) are now the biggest Chinese companies



# The economics of the digital economy

- **Information**, the center-piece of digital economy, is "**non-rival"**, ie individual consumption does not limit supply
- Once produced, it has **virtually zero marginal cost** of production and distribution
- These features make the digital economy **very scalable**: with little effort any new demand can be easily met
- **Strong network/platform** effects: the value of the platform increases with additional users (telephone, Twitter, Facebook…)
    - With *rival goods* too much demand leads to congestion & lowering value; with *non-rival goods* higher demand creates more demand, arising value
- Network effect creates **"winner takes all"** effect, which together with low cost scalability, leads to **huge economic rents for the winners —> rewards seem out of proportion to merit & creates huge income and wealth inequality**
- **Consumer limitations** that rely on default and brand also favour incumbents

# What is the policy concern? Regulation of Bigtech (Furman Report 2019)

- **The digital economy is creating substantial benefits but also risks**
- Digital markets' **'tipping'** where "winner takes all"
- **Concentration in digital markets have benefits but also can give rise to substantial costs**. It can raise effective prices for consumers, reduce choice, or impact quality. Most concerning, it could impede innovation.
- **Market competition will not fix these problems** as incumbents more entrenched than ever. AI and machine learning will further favour incumbents as they process most of the needed data on which profit depends

- **Traditional competition policy tools are not enough/appropriate.** Merger and antitrust enforcement can create delays and uncertainty that can be bad for large incumbents and small entrants alike
- Need for additional policies that actively promote competition:
  - code of conduct for the most significant digital platforms;
  - measures to promote data mobility and systems with open standards;
  - expand data openness.
- The Australian Competition and Consumer Commission (ACCC) (2018) conclusion: 'The ACCC considers that, **like Google, to a large extent, Facebook is insulated from dynamic competition** by barriers to entry and expansion, advantages of scope, and its acquisition strategies."
- Beyond economic considerations there is **worry about enormous wealth accumulation of bigtech**
- **BUT: there is a "regulatory arms race" internationally**

# Issue of size

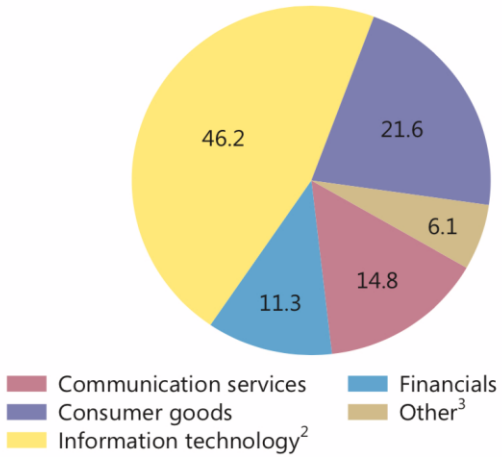
# 3: Bigtech moving into Finance

# Bigtech has started to move into the financial sector…

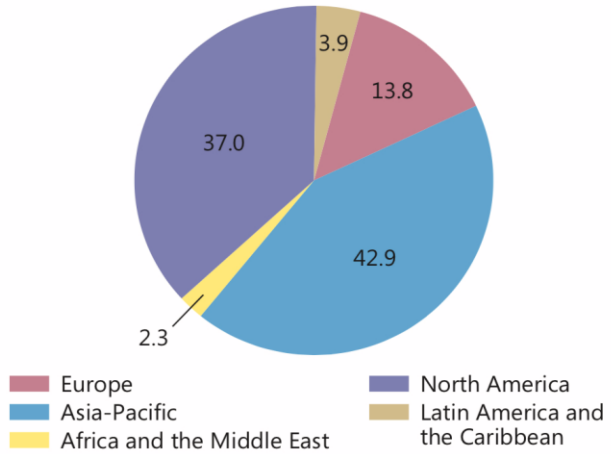
Financial services are a small part of big tech business

In per cent — Graph III.1

Big techs' revenues by sector of activity[1]




Regional distribution of big techs' subsidiaries[4]



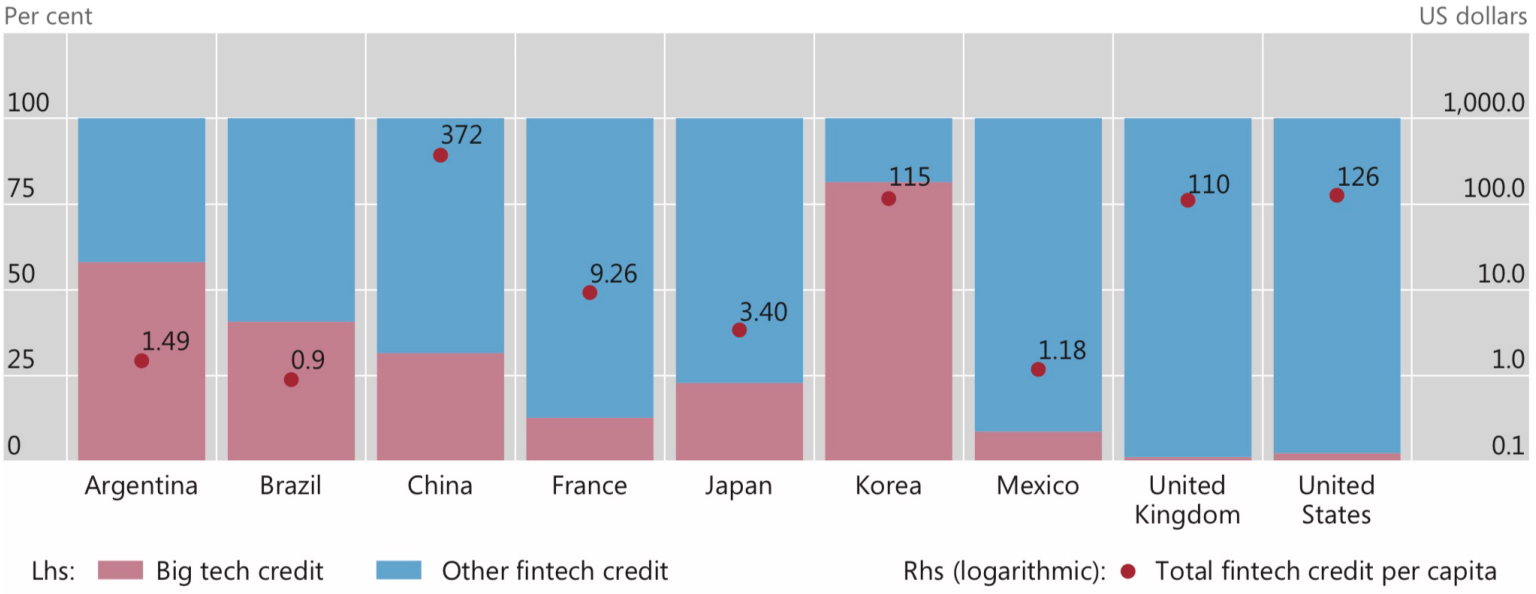

The sample includes Alibaba, Alphabet, Amazon, Apple, Baidu, Facebook, Grab, Kakao, Mercado Libre, Rakuten, Samsung and Tencent.

[1] Shares based on 2018 total revenues, where available, as provided by S&P Capital IQ; where not available, data for 2017. [2] Information technology can include some financial-related business. [3] Includes health care, real estate, utilities and industrials. [4] Shares are calculated on the number of subsidiaries as classified by S&P Capital IQ.

Sources: S&P Capital IQ; BIS calculations.

# … though not yet the dominant player in most countries

Big tech and other fintech credit in selected jurisdictions[1] Graph III.4




[1] The bars show the share of big tech and other fintech credit in selected jurisdictions in 2017, while the dots show total fintech credit per capita.

Source: J Frost, L Gambacorta, Y Huang, H S Shin and P Zbinden, "BigTech and the changing structure of financial intermediation", *BIS Working Papers*, no 779, April 2019.

# China: Typical areas of Bigtech penetration into finance

**What Financial Services Is Big Tech Driving Into?**

Licenses awarded to Chinese tech companies

| | Bank | Third-party payments | Internet fund distribution | Internet microcredit | Mutual fund | Insurance | Insurance brokerage |
|---|---|---|---|---|---|---|---|
| Ant Financial Services Group | X | X | X | X | X | X | X |
| Tencent Holdings Ltd. | X | X | X | X | | X | X |
| JD Digits | | X | X | X | | | X |
| Du Xiaoman Financial | X | X | X | X | | | X |

*Source: S&P, Tech Disruption in Retail Banking, August 2019*

# Regulatory issues of Big Finance meeting Big Tech

- Not too much thinking as yet, except BIS 2019 Annual Report
- The entry of Bigtechs into financial services can have large benefits:
  - could make the sector more efficient via using their extensive personal data for credit risk assessment and lower cost structure
  - increase access to these services (financial inclusion)
- But also introduces new risks: Bigtechs could ignite a **massive change** in financial system; lead to the **emergence of dominant players** that could reduce competition**; and raises the questions of data protection/privacy**
- Regulators needs look at the triangle of financial stability, competition (and innovation) and data protection.

# So far we have focussed on economic risks and concerns…

**Economic risks maybe slightly different among sectors, but the political economy risks are similar**

# ”The Curse of Bigness” by Tim Wu (2018)

- Historically, Supreme Court Justice Brandeis recognised, and successfully fought particularly after the Great Depression/New Deal, the monopoly in the first half of the 20th century (JP Morgan, Rockefeller etc). Issues: cartel pricing, bribes and unchecked political powers
- Pushback in the 1960s/70s by the Chicago School Aron Director and SC Justice Bork reducing antitrust to technical issues
- New Brandeis school:
  - The accumulation of corporate wealth and power in the past decades poses threats to democracy
  - Dictators and monopolists are good bed-fellows
  - Need to revive anti-trust laws across the economy to safeguard democracy
    - ”We have forgotten that antitrust law had more than an economic goal, that it was meant fundamentally as a kind of constitutional safeguard, a check against the political dangers of unaccountable private power“ (Wu in NYT, November 7 2018)

# Conclusion

- Rising market concentration should be a big concern across the whole economy (banking, non-banking, digital economy)
- Digital technology accelerates size/market dominance and makes this problem more urgent to address
- This is also a problem for the political system of democracy. Risks from wealth and power concentration are rising and that itself undermined the capacity for corrective policies. Note: not an issue in non-democracies
- Brandeis et al successfully fought JP Morgan, Carnegie, Rockefeller a century ago … yet in what is now the main competitor China the political economy maybe the opposite
- But still need to act, and also get China on board:
  - Make antitrust policy work again
  - In each sector, the specific economic risks can be regulated, but in view also of the political economy concerns (ie include those in social risks/cost calculations)

**Whether TBTF or TBTS → definitely TBTI**

**=**

**Too-Big-To-Ignore**

# THANK YOU!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