Charles Goodhart and Dirk Schoenmaker

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The Global Investment Banks are now all Becoming American: Does that Matter for Europeans?

Charles Goodhart and Dirk Schoenmaker[1]

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Abstract

In the aftermath of the global financial crisis, the market share of US investment banks is rising, while that of their European counterparts is declining. We present evidence that US investment banks are on the verge of taking over pole position in European investment banking. While the US players have thus become dominant in Europe, China has taken matters into its own hands. Since 2015, Chinese investment banks have overtaken the position of American and European investment banks in the Asian-Pacific market.

Credit rating agencies and investment banks are the gatekeepers of the Capital Markets Union. The European supervisory institutions can effectively supervise the European operations of these US managed players. On the political side, we suggest that the European Commission should keep on viewing its, albeit declining, banking industry as a strategic sector. The Commission, the European Central Bank and the Bank of England should jointly develop a strategic agenda for the EU-US Regulatory Dialogue.

Finally, corporates rely on investment banks to issue new securities. We recommend that the big European corporates should cherish the (few) remaining European investment banks, by giving them at least one place in a further US dominated banking syndicate. That could help to avoid complete dependence on US investment banks.

[1] Charles Goodhart is Emeritus Professor at the Financial Markets Group, London School of Economics, and Dirk Schoenmaker is Professor of Banking and Finance at Rotterdam School of Management, Erasmus University, and Senior Fellow at Bruegel. They would like to thank two anonymous referees and participants at the Journal of Financial Regulation 2016 Annual Conference for useful comments. They are also grateful to Elena Vaccarino, Pia Huettl and Uuriintuya Batsaikhan at Bruegel for excellent research assistance and to colleagues at Bruegel and various informed contacts for their insights during the writing of this paper.

1. Introduction

Europe's banks are in retreat from playing a global investment banking role. This should not be a surprise. It is an, often intended, consequence of the regulatory impositions of recent years, notably of the ring-fencing requirements of the Vickers Report (2011)[2] and the ban on proprietary trading by Liikanen (2012)[3] to reduce the exposure of tax-payers, but also including the enhanced capital requirements on trading books and other measures. The main concern is that a medium-sized European country, such as the United Kingdom or Switzerland, or even a larger country like Germany, let alone a tiny country like Iceland or Ireland, would find a global investment bank to be too large and too dangerous to support, should it get into trouble[4]. So, one of the intentions of the new set of structural regulations was to rein back the scale of European investment banking to a more supportable level.

The European Union, of course, has a much larger scale than its individual member countries. If the key issue is the relative scale of the global (investment) bank and state that might have to support it, could a Europe-based global investment bank be possible[5]? We doubt it, primarily because the EU is not a state. It does not have sufficient fiscal competence. Even with the European Banking Union and European Stability Mechanism, the limits to the mutualisation of losses, eg via deposit insurance, mean that the bulk of the losses would still fall on the home country (Pisani-Ferry and Wolff, 2012). Moreover, there would be intense rivalry over which country should be its home country, and concerns about state aid and the establishment of a monopolistic institution. While the further unification of the euro area might, in due course, allow a Europe-based global investment bank to emerge endogenously, we do not expect it over the next half-decade or so.

So the continuing withdrawal of European banks from a global investment banking role is likely to continue. That will leave the five US bulge-bracket banks, (Goldman Sachs; Morgan Stanley; J.P.

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[2] The Independent Commission on Banking, chaired by Sir John Vickers, produced its final report in 2011, suggesting inter alia that UK banks should "ring-fence" their retail banking divisions from their investment banking arms to safeguard against riskier banking activities. It laid the ground for the FINANCIAL SERVICES (BANKING REFORM) ACT 2013, C. 33.

[3] High-level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, FINAL REPORT, Brussels, October 2012, available at <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf>. Follow-up legislative activity is still in the making, see European Commission, PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON STRUCTURAL MEASURES IMPROVING THE RESILIENCE OF EU CREDIT INSTITUTIONS, COM(2014) 43 final, January 29, 2014. Several countries, like France, Germany and The Netherlands, have already adopted elements of the Liikanen report in their national legislation.

[4] See for example commentary by Martin Wolf in the *Financial Times* and other recent coverage: *Financial Times* (2015a, 2015b), Gapper (2015), Oudéa (2015) and *The Economist* (2015).

[5] As suggested for example by *Financial Times* (2015a).

Morgan; Citigroup; and Bank of America Merrill Lynch) as the sole global investment banks left standing. The most likely result is a four-tier investment banking system.

The first tier will consist of these five US global giants. The second tier will consist of strong regional players, such as Deutsche, Barclays and Rothschild in Europe and CITIC in the Asian-Pacific region. HSBC is in between, with both European and Asian-Pacific roots. The third tier consists of the national banks' investment banking arms. They will service (most of) the investment banking needs of their own corporates and public sector bodies, except in the case of the very biggest and most international institutions (who will want global support from the US banks) or in the case of complex, specialist advice. Exemplars of this third tier are to be found in the roles of Australian and Canadian banks, which support their own corporates and public sector bodies without extending into global investment banking. The fourth tier consists of small, specialist, advisory and wealth management boutiques.

Why should it matter if in all the European countries the local banks' investment banking roles should retrench to this more limited local role? After all, there are few claims that Australia and Canada have somehow lost out by not participating in global investment banking. We review the arguments in section 4. Before doing so, we take a closer look at the investment banking market in Europe. Section 2 investigates the development of the relative market share of US and European investment banks over time. It appears that the US investment banks are about to surpass their European counterparts in the European investment banking market. Section 3 examines how the US investment banks operate in Europe. We find a typical pattern of a large London head-office (site of their financial experts, including traders) and a small sales-force in major European capitals. We also analyse the likely impact of Brexit. Finally, we discuss the policy implications in Section 5.

2. The rise of US and decline of European investment banks

Before embarking on an empirical investigation of the market shares of the leading US and European players, we first define the scope of investment banking activities and the role of investment banks in the financial system.

2.1. The function of investment banks

Investment banks play a key role in financial markets by bringing together the suppliers of capital (i.e. investors) and those in demand of capital (i.e. corporates, governments and households). In this way, investment banks are the gatekeepers of the Capital Markets Union, which aims to improve access to funding, allocation of capital, prospects for savers and financial stability in the European Union (Véron and Wolff, 2016). The European Commission, which has initiated the Capital Markets Union project, has therefore a keen interest in the proper functioning of these gatekeepers from an economic perspective. But there is also a political dimension, as in the case of credit rating agencies. Would it be acceptable to rely on US players, for these important components of the financial system? We turn to that dimension in Section 4.

On the demand side for capital, corporates are the largest group.[6] The provision of corporate finance is the traditional métier of investment banks, which involves helping customers raise funds in capital markets and giving advice on mergers and acquisitions (M&A). This may involve subscribing investors to a security issuance, coordinating with bidders, negotiating with a merger target, and liaising with regulators (both competition and financial regulatory authorities) and governments. One of the main roles of investment banks in M&A is to establish fair value for the companies involved in the transaction. They are also able to predict how that worth could be altered (i.e., what happens to the value of a company in a number of different scenarios and what those potential futures would mean financially). A pitch book of financial information is generated to showcase the bank to a potential M&A client. If the pitch is successful, the bank arranges the deal for the client.

While investment banks used to underwrite almost all equity and bond issues, their role has now shifted to placing capacity with investors. So most placements are done on a best efforts basis; only rights issues are still underwritten by the investment banks. Quality and reputation are the key ingredients for an investment bank's success, for which corporates are paying.

As both US capital markets and US corporates are by far the biggest across the world, it is no surprise that US investment banks are leaders in global investment banking. However, US investment banks on Wall Street have close ties with the US government in Washington DC, as witnessed during the global financial crisis. US Congress can easily pass new laws with extra-territorial reach (e.g. Sarbanes-Oxley). Next, we have seen episodes where US banks and corporates were acting on stringent orders from Washington (e.g. SWIFT, Cuba, Iran). What if these orders turn against Europe? We leave that for Section 4.

2.2. Market share of US and European investment banks in Europe

While the US investment banks are the global leaders (see below), what is their share in the European investment banking market? The famous investment bank league tables rank investment banks by market share. These tables typically cover four major segments: M&A, Equity, Bonds and Loans (i.e.

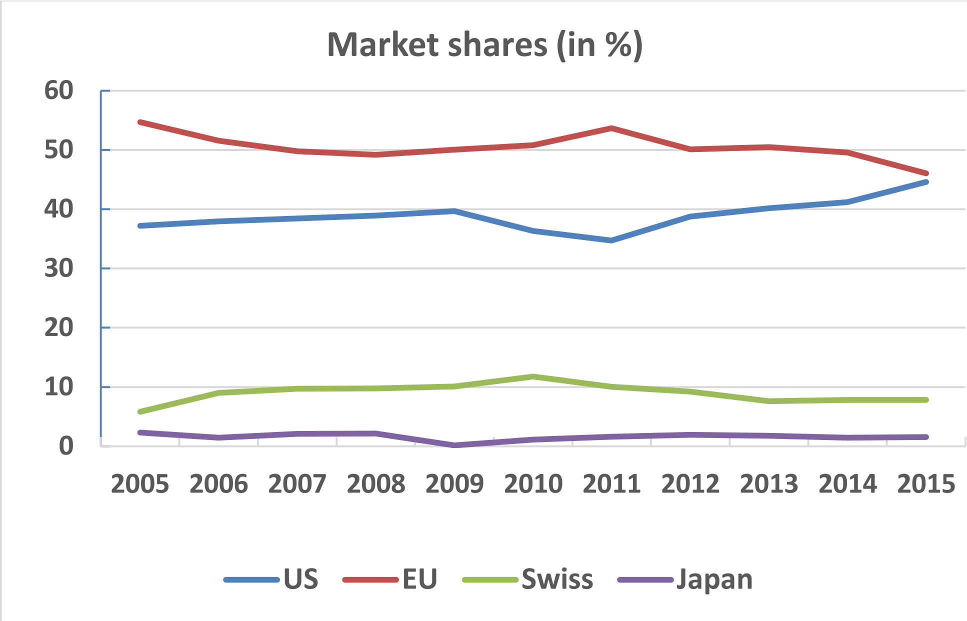
[6] Governments, and other public sector bodies, also use investment banks to place their bonds in the capital markets (e.g. through a system of primary dealers). This is outside the scope of this paper.

syndicated loans). We have calculated the weighted average of investment banking proceeds of the top 20 players across these four segments for Europe (i.e. the market share in each segment is weighted by the relative size of that market segment in total investment banking business). Global data are usually split into Americas, EMEA (Europe, Middle East and Africa), Asia-Pacific and Japan, but we have only EMEA data. However, Europe comprises the vast majority of EMEA investment banking. Data are taken from Thomson Reuters and cover the period from 2005 to 2015. To select the top 20, we take the 11-year average across all investment banks, and use that ranking for all years.

Table 1 in the Annex provides the detailed market shares of the top 20 investment banks. It appears that the top 20 covers about 80 percent of the EMEA investment banking market. Figure 1 summarises the results. The market share of EU and Swiss investment banks has declined since 2010/2011, while the share of US investment banks (the big five and Lazards) has increased from 35 percent in 2011 to 45 percent in 2015. It should be noted that the evolution of the regional market shares reflects partly the broader banking crisis dynamics. US investment banks were first hit in the global financial crisis and declined from 40 percent in 2009 to 35 percent in 2011, but recovered after the decisive recapitalisation exercise enforced by the US Treasury. The Swiss decline set in in 2010 and the EU decline in 2011. Although part of the European decline is cyclical (on-going subdued growth in the aftermath of the euro-sovereign crisis), we contend that most of the decline is structural due to the structural regulatory measures to downscale the European (investment) banking sector discussed in the introduction.

However, the European share of the investment banking market remains larger than the alarming articles in the introduction might have suggested. While they lose business in the global investment banking market (see Figure 2 below), they have still a strong, albeit declining, presence in Europe, serving the many smaller and mid-sized corporates. Nevertheless, Figure 1 shows an underlying structural trend, whereby EU and Swiss investment banks are downsizing. If the trend were to continue, US investment banks would overtake the prime spot from their EU counterparts soon, possibly already in 2016.

Figure 1: Market share of investment banks in EMEA (in %)

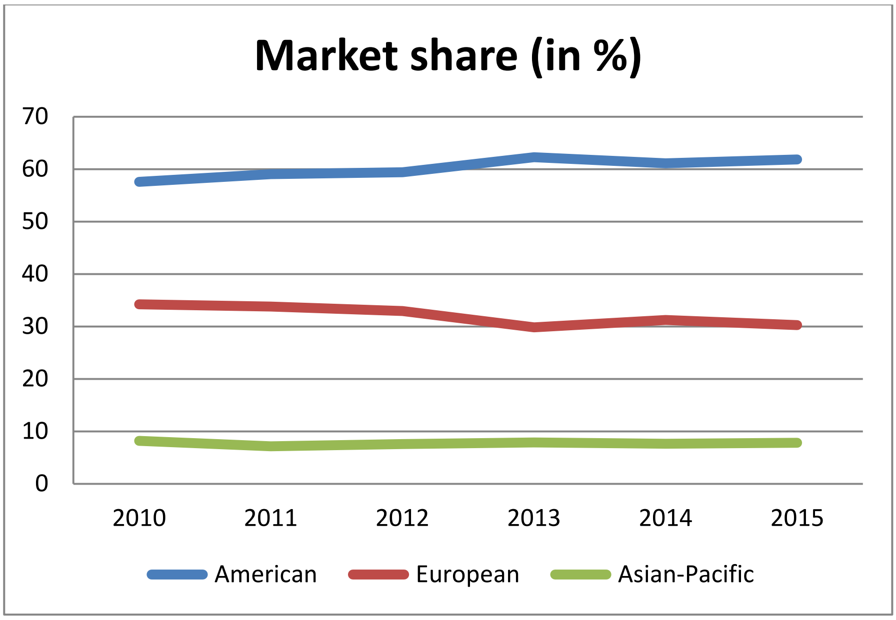


Source: Bruegel calculations based on Thomson Reuters data.
Note: The figure depicts the relative shares of the EMEA investment banking market held by the top 20 investment banks, grouped by origin: EU, US, Switzerland, Japan. Europe comprises the vast majority of EMEA (Europe, Middle East and Africa) investment banking.

2.3. Global investment banking

To complete our picture of investment banking, we have also calculated the market shares for global investment banking as well as in the other major regions. For these calculations, we have taken market shares by investment banking fees. These data are again taken from Thomson Reuters, but are only available from 2010 onwards. Figure 2 shows the share of American (US and Canadian) investment banks increased from 58 percent in 2010 to 62 percent in 2015, while the share of European (EU and Swiss) players decreased from 35 to 30 percent over the same period. This confirms the general picture of the rise of American investment banks and the decline of European ones.

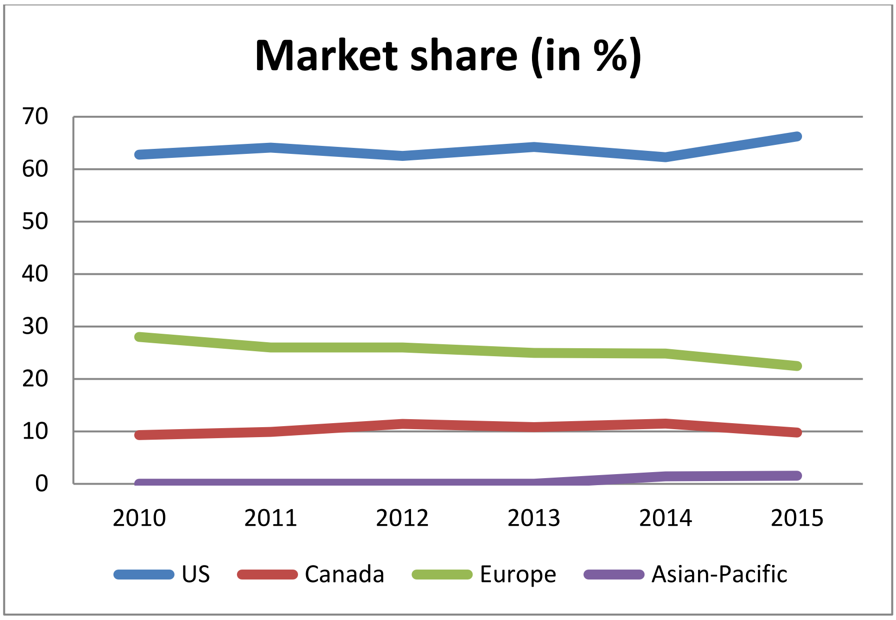
Figure 2: Market share in global investment banking (in %)



Source: Bruegel calculations based on Thomson Reuters data.
Note: The figure depicts the relative shares of the global investment banking market held by the top 20 investment banks, grouped by origin: Americas (US and Canada), Europe (EU and Swiss) and Asia-Pacific (Japan).

Turning to the Americas, the picture is even stronger. Figure 3 indicates the rise of US investment banks (from 63 to 66 percent) and the decline of European investment banks (from 28 to 22 percent) in the American investment banking market. This is in line with the broader retreat of European banks from the US. It should be noted that before the global financial crisis the European banks had an overly large presence in the US; so there was a bias towards the US in the foreign operations of European banks (Schoenmaker and Wagner, 2013). From the Asian-Pacific region, only the Japanese investment banks operate on a global scale. While the Chinese investment banks are on the rise (see below), they have confined themselves so far to a local role.

Figure 3: Market share of investment banks in Americas (in %)



Source: Bruegel calculations based on Thomson Reuters data.
Note: The figure depicts the relative shares of the American investment banking market held by the top 20 investment banks, grouped by origin: US, Canada, Europe (EU and Swiss) and Asia-Pacific (Japan).

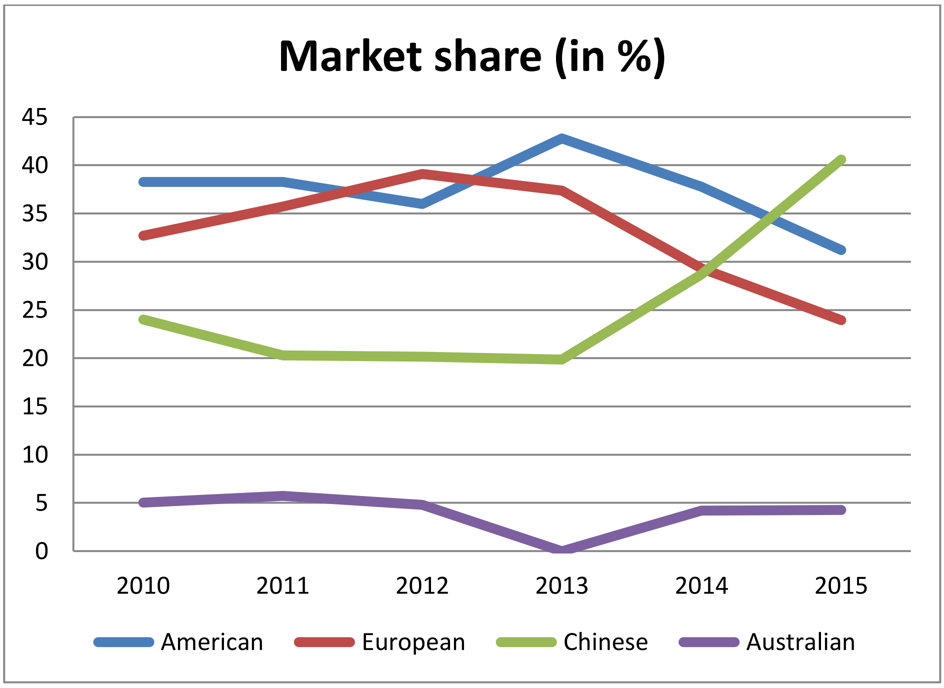
Finally, we analyse the Asian-Pacific and Japanese investment banking market. These are separately calculated by Thomson Reuters. Figure 4 shows some strong and interesting trends. The market share of both US and European investment banks have tumbled over this short period. The US investment banks drop from 38 to 31 percent and the European ones from 33 to 24 percent. The Chinese investment banks have now become the largest players in their own region with a market share 41 percent in 2015. This reflects the increasing professionalism and self-confidence of Chinese investment banks. These local investment banks are also better placed to understand, and liaise with, the Chinese corporates, regulators and party/government.

HSBC Group is a global bank, with a strong presence in Europe (42 percent of its total loan book) and Asia (37 percent of its total loan book). Moreover, the Hongkong and Shanghai Banking Corporation (the Hong Kong subsidiary of HSBC Group) is the largest bank in Hong Kong. It would be interesting to see whether it fits the declining path of the European players or the rise of the Chinese banks. The market share of HSBC in Asian-Pacific investment banking rose from 1.7 percent in 2010 to 2.9 percent in 2015. While HSBC is ranked under European banks (due to its head-quarters in London), it thus follows the pattern of Chinese based investment banks taking over from their US and European counterparts.

Figure 5 shows the Japanese investment banking market. This picture highlights the traditionally relative closed nature of the Japanese banking market, with more than 70 percent market share for domestic players. Nevertheless, there is a decline of the market share of the Japanese investment banks from 71 percent in 2010 to 67 percent in 2015. This part of the market is taken over by the American investment banks, which increased their market share from 24 to 28 percent during this period.

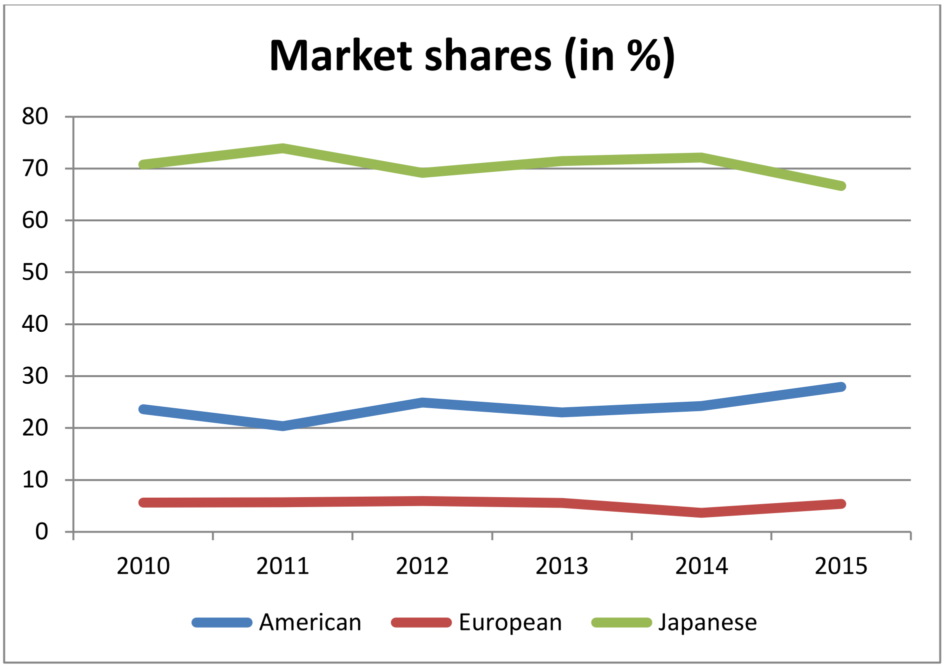
While the Chinese and Japanese investment banks are the dominant players in their own markets, these markets are far smaller than the American and EMEA investment banking markets. Thomson Reuters (2016) provides data on total investment banking fees for the various geographical regions: Americas $ 48.6 bn; EMEA $ 22.1 bn; Asia-Pacific $ 12.6 bn; and Japan $ 3.6 bn in 2015. This reconfirms the overall picture that the five US investment banks are the global leaders, with leading positions in the major American and European markets (see also Figure 2).

Figure 4: Market share of investment banks in Asia-Pacific (in %)



Source: Bruegel calculations based on Thomson Reuters data.
Note: The figure depicts the relative shares of the Asia-Pacific investment banking market held by the top 20 investment banks, grouped by origin (Americas (US and Canada), Europe (EU and Swiss), China and Australia. Japan is not included in the Asia-Pacific market data.

Figure 5: Market share of investment banks in Japan (in %)



Source: Bruegel calculations based on Thomson Reuters data.
Note: The figure depicts the relative market share of American (US and Canada), European (EU and Swiss) and Japanese investment banks in the top 20 of the Japanese investment banking market.

3. How do US investment banks operate in Europe?

An interesting question is how the US investment banks operate across Europe. That is difficult to answer, as investment banks, like any large corporate, are not very transparent about their precise geographic location of their operations. But under the recent Capital Requirements Directive (CRD IV; 2013/36/EU), financial institutions must disclose, by country in which they operate through a subsidiary or a branch, information about turnover, number of employees and profit before tax. These so-called country-by-country (CBC) reports allow us to refine the geographical split at country level. From the 2014 CBC reports of the five US investment banks, we take the investment banking activities across Europe and exclude the commercial banking activities of Citi, Bank of America and JP Morgan Chase. In two cases (Citigroup, JP Morgan), some EU countries are not covered in the main CBC reports. We use additional documents for these banks.[7]

3.1. The hub and spoke model

Tables 2 and 3 in the annex contain a detailed breakdown of turnover and employees in 2014 for the five US investment banks. Figure 6 and 7 illustrate the aggregate breakdown for the five banks. The

[7] The Base Prospectus for Citigroup Global Markets Deutschland dated 30 April 2015 for Citigroup and additional information from the 2014 Annual Report for JP Morgan, to ensure that all the geographic entities in the European Union are included in the dataset.

Figures show visibly how the US investment banks apply the hub and spoke model in their European operations. These banks use the international financial centre of London -with a skyscraper in the City or Canary Wharf- as the main hub (with more than 80 percent of business) with spokes to the other larger and mid-sized European countries. They have no operations in the smaller markets, such as Austria, Finland, Portugal and the Baltics. In central and eastern Europe, they have only a small presence in the largest country, Poland.

A few capitals act as sub-hubs. Frankfurt and Dublin are the larger sub-hubs with more than 2 percent of business. Frankfurt has emerged as the financial capital of the Eurozone. The rise of Frankfurt can be explained by the presence of the European Central Bank, which has expanded from monetary policy towards banking supervision. Moreover, Frankfurt is the financial capital of Germany, the largest and strongest European country, which reinforced its dominant position during the euro sovereign crisis. By contrast, Dublin is located in one of the smaller countries, but has a favourable tax regime and belongs, together with the United Kingdom, to the group of English speaking countries. Americans find it easier, also culturally, to set up office (and home) in these countries. Finally, Luxembourg and Paris are smaller sub-hubs with more than 1 percent of business.

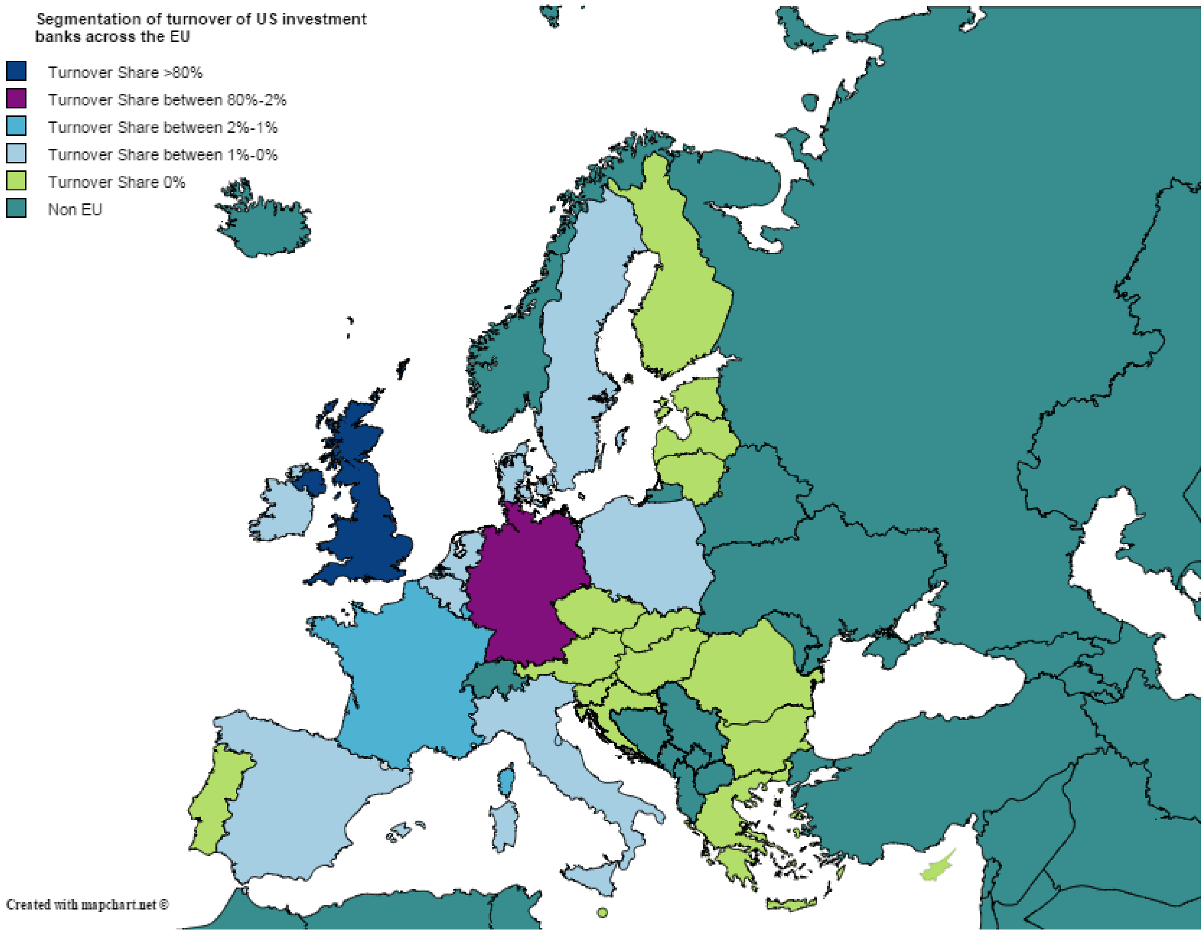
So, the large London head-office contains the vast majority of an investment bank's financial experts and traders, with some further specialists based in Frankfurt and/or Dublin. The investment banks have a small sales-force in the remaining (major) European capitals. These account mangers speak the local language and liaise between the local clients, who prefer to do business with their country fellow man, and the London experts. An interesting detail is that the US investment banks actively attract financial talent across Europe to ensure that the main nationalities (and cultures) are present in their London team, and also grow into senior positions.[8] Appointing Europeans to key positions helps in liaising with European corporates, investors, regulators and governments, which is an important part of the investment banking function.

The hub and spoke model is reinforced by the drive towards regulatory efficiency. The US investment banks prefer to deal with one regulator for their European operations. That is obviously the regulator in the main hub. For prudential matters, the Bank of England's Prudential Regulatory Authority has the supervisory power under the Capital Markets ~~Second Banking~~ Directive (CRD IV;

[8] An example of this local hiring policy is the annual International Banking Cycle in the Netherlands, where the major (US) investment banks give a joint road show at the Amsterdam and Rotterdam universities to hire graduates.

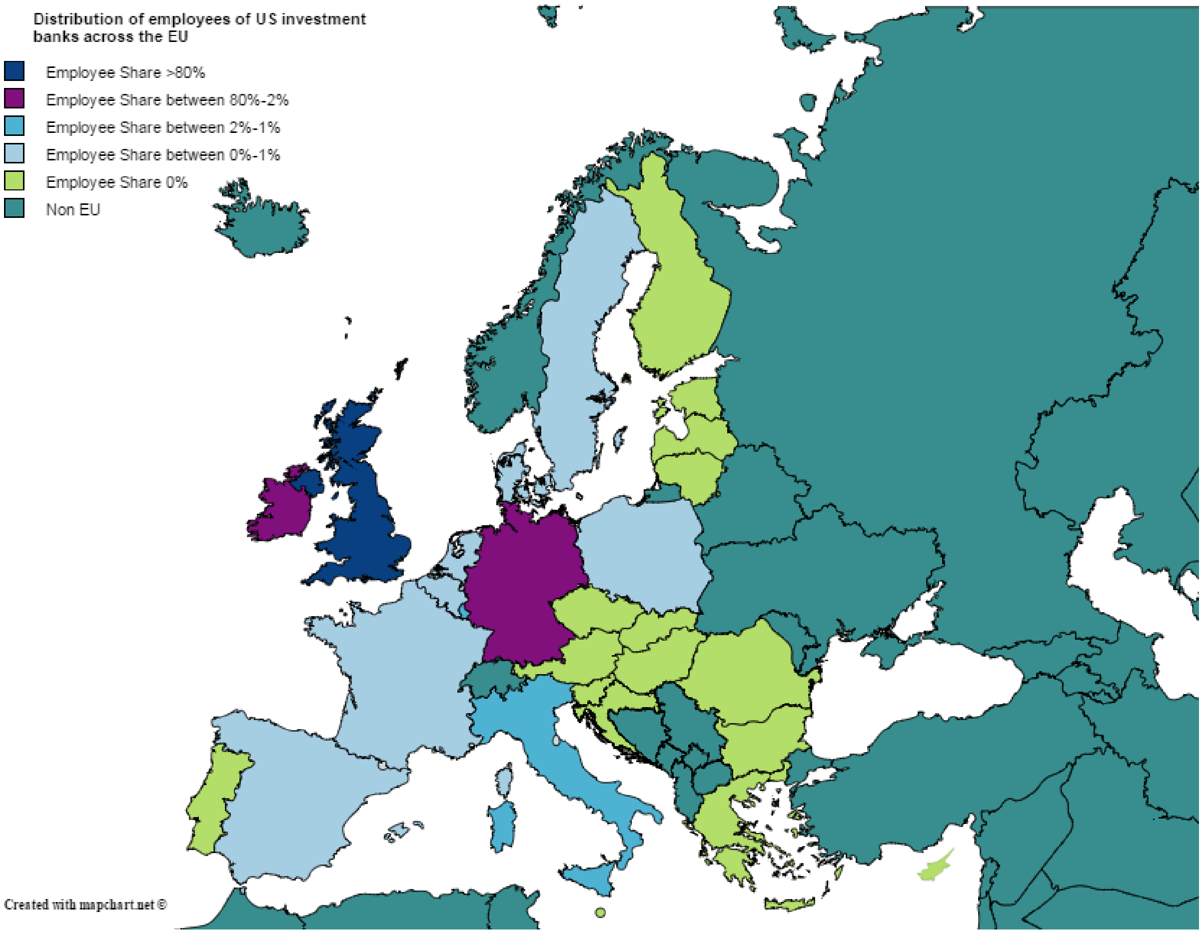
2013/36/EU~~89/646/EEC~~) over the European operations of the US investment banks. The UK licence can then be used to passport throughout the European Union. Similarly, the Financial Conduct Authority supervises the market operations under the Markets in Financial Instruments Directive (MiFID; 2004/39/EC; shortly to be replaced by MiFID II (2014/65/EU)), and offers a European passport for these activities. Insofar as the US investment banks have additional subsidiaries across the EU, the respective country supervisor (e.g. ECB/Bafin for Citigroup Global Markets Deutschland AG) has supervisory control over these subsidiaries.

Figure 6: US investment banks – segmentation of turnover across the EU (2014)



Source: Bruegel calculations based on Country-by-Country Reports of the 5 US investment banks.
Note: The figure depicts the segmentation of turnover of the 5 large US investment banks across the EU (calculated as a weighted average). The main hub is dark blue (share > 80%), the larger sub-hub is purple (share > 2%), the smaller sub-hubs are light blue (share > 1%). In the remaining EU countries, the investments banks have a minor presence – grey (between 0 and 1%) or no presence – light green (share 0%).

Figure 7: US investment banks – segmentation of employees across the EU (2014)



Source: Bruegel calculations based on Country-by-Country Reports of the 5 US investment banks.
Note: The figure depicts the segmentation of employees of the 5 large US investment banks across the EU (calculated as a weighted average). The main hub is dark blue (share > 80%), the larger sub-hubs are purple (share > 2%), the smaller sub-hubs are light blue (share > 1%). In the remaining EU countries, the investments banks have a minor presence – grey (between 0 and 1%) or no presence – light green (share 0%).

3.2. Consequences of Brexit

Our analysis shows that London is not only an international financial centre, but also a gateway to Europe for the large US and Swiss (investment) banks. These banks use their UK banking licence(s) as passport for their operations throughout the European Union. That might not be possible anymore after ~~in the unfortunate case of~~ Brexit. Although various scenarios ~~(~~from a 'Norway' deal (see below) to a loose free trade pact ~~)~~ can be drawn, investment banks have an overriding interest to safeguard their European passport. The~~A potential~~ vote for Brexit in the 23 June referendum ~~would be~~is the starting point for negotiations between the United Kingdom and the European Union on a new cooperation model. Such negotiations can easily last several years, with lingering uncertainty about the outcome during this period. Investment banks hate uncertainty. Moreover, their clients want to know what to expect (under which law are their securities issued, etc). So, investment banks are making preparations for relocating (part of) their business and their regulatory passport~~, if needed in the case of Brexit~~.

Speculation ha~~i~~s already started~~ing~~ whether the investment banks might move their European head-office to Frankfurt, Dublin, Paris or the outsider Amsterdam. In the aftermath of the global financial crisis, Ireland would not be very keen to host these large banks. Hosting banks brings not only benefits (e.g. employment and taxes), but also costs as fiscal backstop to the banking system (Schoenmaker, 2015). The latter can in particular be costly for small countries. With the establishment of Banking Union, the European Central Bank instead of the national supervisor would become the supervisor when the assets of the relocated investment bank exceed €30 billion according to the SSM Regulation (No 1024/2013). Resolution would accordingly be done by the Single Resolution Board (SRM Regulation No 806/2014). But in the eight year transition period starting in 2016 to build up the Single Resolution Fund (SRF), the participating countries still provide national credit lines as backstop to the SRF, which leaves the fiscal backstop at the national level.[9]

The US investment banks we~~a~~re happy with their ~~current~~ presence in London; HSBC also recently reconfirmed to stay in London and not to relocate to Hong Kong. The Anglo-Saxon culture, both for business (free market driven) and private residence, suits them well. It is no surprise to see that the US investment banks we~~a~~re vocal in the Brexit debate on staying inside the European Union. In contrast, some London-based hedge funds campaigned for Brexit. The ensuing volatility of a Brexit is, as was anticipated, ~~could be~~ a fertile trading ground for hedge funds. Moreover, a United Kingdom outside the European Union would be less (over)regulated. They perhaps guess, rightly or wrongly, that the United Kingdom will strike some trade deal with the European Union after ~~a potential~~ Brexit. But the more such a deal resembles the Norwegian membership of the European Economic Area (EEA) with pass-porting rights into the European Union, the more the United Kingdom will have to adopt the full regulatory acquis of the European Union. The only difference is that the United Kingdom would have no voting seat at the negotiation table for new Directives and Regulations.[10]

4. Concerns for Europe

[9] Statement on Banking Union and bridge financing arrangements for the Single Resolution Fund, 884/15, ECOFIN, 8 December 2015.

[10] One of the authors participated in several negotiations on new financial rules in Brussels. He always felt sorry for the EE~~FT~~A countries, like Norway and Iceland, which were allowed to attend the meetings but had little say and no voting power.

We now turn to the consequences of the rise of US investment banks and the decline of their European counterparts. Why should it matter if in all the European countries the local banks' investment banking roles should retrench to a more limited local role? After all, there are few claims that Australia and Canada have somehow lost out by not participating in global investment banking.

4.1. Regulatory dialogue

There are~~, perhaps, three,~~ four inter-related arguments why leaving global investment banking to the big five American banks might be problematical. The first is that this could leave Europe at greater risk from, possibly ill-advised, American political or regulatory intervention. Thus Oudéa (October 12), wrote that,

> "In the last crisis, American banks came under intense pressure to reduce their European assets. Having banks able to finance European companies is an essential part of the EU's economic sovereignty. Europe's industrial champions will be at a serious disadvantage if they cannot rely on access to capital when their rivals in America and China can."

While this danger exists, it was already present before the withdrawal of European banks from global investment banking. Since the US dollar and US financial markets play the central role in the financial system, the US is in a position to enforce its demands on acceptable counterparty transactions and to dominate, for good or ill, the international monetary policy scene, whether, or not, the big five US banks are the only global bulge banks left standing. It is, perhaps, another slight turn of the screw, but the European banking system has already been thoroughly screwed in this respect.

As discussed earlier, Washington has, and had, no problem in enacting far-reaching regulations, like Sarbanes-Oxley for corporates (Lanois, 2007), or the leverage ratio for banks operating in the US (pre-Basel 3). Similarly, the European Commission started to put clauses in Directives to give themselves the powers to recognise (or not) the equivalence of US, Swiss, and other country's regulation and supervision (e.g. in the Financial Conglomerates Directive 2002/87/EC). The European Commission and the US authorities therefore set up a EU-US Regulatory Dialogue to discuss bilateral regulation issues. In some cases, the parties reached consensus (e.g. exemption of European banks from the leverage ratio for their operations and recognition of US prudential regulation and supervision as equivalent for financial conglomerates). In other cases, there is no consensus. A case in point is the accounting rules. While Europe adheres to the IFRS (International Financial Reporting Standards), the US sticks to its US GAAP (General Accepted Accounting Principles).[11]

[11] See Véron (2007).

A recent issue in the bilateral negotiations is the new US requirement for an Intermediate Holding Company (IHC) for large US operations (with more than $50bn of assets) of foreign banks. In that way, the US Federal Reserve can exercise full control over the US operations of European (and other foreign) banks. By requiring separate capitalisation of the US operations, the rule could reduce bank profitability at the parent level and induce organisational changes.[12] ~~The Bank of England's Prudential Regulatory Authority has answered with a similar subsidiary requirement for large operations of US banks in the United Kingdom.~~

4.2. Regulation and supervision

The second concern is whether we can regulate and supervise these large global banks. Ringe (2016) describes several approaches for international regulation and supervision. The first would be harmonisation of regulations and enforcement of these international regulations by an international institution like the IMF, as proposed by De Larosière (2009). But that is not likely in the current environment. The second and more realistic (and natural) reaction to the problem of international diversity is the attempt by lawmakers to achieve an extraterritorial reach of their laws. Thus, where regulators are not able to convince their foreign counterparts to enter into a mutual agreement or reach convergence, they might attempt to push through their concepts by way of unilateral action. The earlier described Sarbanes-Oxley Act is an example of extraterritorial action in the field of securities law.

Ringe (2016) argues that extraterritorial rules do not only clash with an international comity ideal, but also ignore the opportunity to achieve regulatory goals through policies of equivalence and mutual recognition, and they increase the potential for conflicting or duplicative regulatory policies. The European Commission has adopted the principles of equivalence and mutual recognition for international regulation and supervision.

A third approach is regulatory competition. This might, however, reinforce the procyclical working of regulation, both in the field of securities regulation and prudential supervision. While we witnessed a race to the bottom before the crisis (e.g. Ireland and Luxembourg for investment funds), we now see a

[12] FEDERAL RESERVE SYSTEM (2014), Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 12 CFR Part 252 [Regulation YY; Docket No. 1438] RIN 7100–AD–86, Federal Register / Vol. 79, No. 59 / Thursday, March 27.

race to the top (e.g. Sweden, Switzerland and the UK concerning capital rules for large banks). Concluding, we believe that the application of the mutual recognition approach is the most promising and will discuss that in more detail in the next section.

A final question is whether any supervisor can deal with the sheer size and complexity of investment banks whatever their nationality? The prudential supervision of US investment banks has been much improved, with the move of the primary prudential responsibility for investment banks during the crisis from the SEC, which is basically a legal-based securities regulator, to the Federal Reserve, which is a true prudential banking supervisor. Similarly, prudential supervision in the UK has been improved with the move of prudential supervision from the stand-alone Financial Services Authority to the newly established Prudential Regulatory Authority at the Bank of England. But two basic problems for dealing with international banks are still there, as we have argued elsewhere. The first is the lack of a legally binding requirement for coordination between national supervisors and resolution authorities.[13] The second is the lack of an international framework for the resolution of international banks.[14]

~~4.2.~~4.3. Competition

Five is not a large number. So, the ~~second~~ third argument is that this will leave global investment banking much more concentrated. Is not this potentially dangerous? Perhaps, but these five banks still compete quite ferociously, so margins are not rising all that much. Indeed, but the current economic pressures, especially of much greater capital requirements, impact on the US banks, just as much as on the European banks through the international framework of Basel 3. What would happen if one, some, or all of these US banks decided to follow the European banks and to withdraw from providing global investment banking services in Europe, especially in London?

But, to some large extent, greater concentration, higher margins and less liquid markets are the inevitable cost of imposing much higher prudential requirements. If much more capital is required to backstop risk-taking in such activities, then margins must rise until the capital employed in such activities earns the (risk-adjusted) equilibrium rate. This means that weaker competitors must depart, and concentration rises, until equilibrium is restored. It is arguable, at least, that the sooner such equilibrium is, once again, reached, the better. Perhaps it would be good, rather than bad, if one, or two, of the US big five also packed up and left? If the authorities should become unhappy with the

[13] See Goodhart and Schoenmaker (2009).
[14] See Avgouleas, Goodhart and Schoenmaker (2013).

consequences of regulatory reform, they should have thought about all this at an earlier stage. It is a bit late to get upset now. We see no major competition policy concerns at this stage.

~~4.3.~~4.4. European banking becoming parochial?

The ~~third~~ fourth argument is that current developments are inducing European banks more and more into concentrating on their national roles and clients, in their (investment) banking operations, rather than taking a wider European stance. Table 1 illustrates that Deutsche,~~ and~~ Barclays and HSBC are the only Europeans left in the top 8~~7~~ for the EMEA market in 2015. But the first two~~y~~ are likely to lose their position, as Deutsche is currently undergoing a major reorganisation and Barclays is in the process of executing the Vickers split. In the investment banking field, the only pan-European banks will all soon be American! This has the corollary, for good or bad, that the European authorities, whether national or European-wide, such as the European Commission, will have rather less direct purchase on (or control over or ability to bully) them. A key part of the European financial system is slipping out of the grasp of the European authorities.

It is, one might think, anomalous that, at a time when the European authorities are trying to establish a banking union and a capital markets union, the effect of their regulatory reforms has been to cause EU banks to concentrate their focus on their national roles, leaving the US banks as the only pan-European actors on this particular stage. But does it matter? Might it, perhaps, be good if the European authorities now find that their power to control and to coerce the key lending investment banks has become rather more limited? Having consciously tethered their own banks, they are left dependent on those banks where their ability to subject them to their demands is rather less.

There are concerns about US dominance in European investment banking. These are related to information advantages, ~~and~~ soft relationships and extraterritoriality. The rise of Chinese investment banks to support the international expansion of Chinese corporates is a strong countervailing power to US and European investment banking dominance. The question arises whether US investment banks, as outsiders, are sufficient knowledgeable about European corporates. Moreover, what is the loyalty of these US banks to European corporates in times of distress? Next, there are concerns of corporate culture. Not long after successfully taming the global financial crisis, US financial firms resumed their practice of paying high salaries and bonuses. In contrast, Europe enacted caps on bonus payments. The large (US) investment banks are already trying to exempt their high-flyers in London from these EU rules, by arguing that these managers have a 'global' role and should therefore be remunerated by international rather than European standards. On extraterritoriality, US authorities can request information from US investment banks about foreign clients in foreign locations. To reduce this risk, Goldman Sachs is, for example, planning to establish its Hong Kong subsidiary, Goldman Sachs Asia Bank Limited, as a stand-alone subsidiary for all its Asian business without a parent guarantee.[15]

5. Policy response and conclusions

The European banking system is downsizing, partly because of on-going problems, partly because Europe is overbanked (Langfield and Pagano, 2016). That should run its course. The consequence is that the big US investment banks will be the sole leaders in the global investment banking market, as the Europeans, including the Swiss, are in retreat. We also find that the big five Americans are getting into pole position in the European investment banking market.

What should be the policy response? First, we look at the political side. With the decline of European banking (both in general and specifically investment banking), Europe's hand in the EU-US Regulatory Dialogue is diminishing. Nevertheless, the European Commission is advised to bolster its political stance in the EU-US bilateral negotiations and keep on viewing its banking industry as a strategic sector, as availability of finance for companies is important for the functioning of the European economy.

The emerging role of the European Central Bank (ECB), both on the monetary and the supervisory side[16], can be used in these negotiations. Of the 30 global systemically important banks (so-called G-SIBS), eight are located in the US and eight in the Banking Union Area. A further four G-SIBs as well as the European head offices of the US investment banks are based in the United Kingdom under the supervisory watch of the Bank of England. The European Commission, the ECB and the Bank of England should therefore jointly develop a strategic agenda with European priorities for their dealings with the US authorities (assuming that the UK authorities will continue to cooperate with its European counterparts after Brexit). As in the US, this strategic agenda should be discussed with, and supported by, the industry. A strong and united front would enhance Europe's position.

Second, we turn to the supervisory side. While Europe may lose some political clout, we can deal with some of the supervisory implications. With the move to capital markets union, the European supervisory architecture can handle the gatekeepers, which are becoming more US dominated. ESMA, the European Securities and Markets Authority, has powers under the Regulation on Credit Rating Agencies (EC/1060/2009) to licence and supervise the European operations of the primarily US based credit rating agencies. Similarly, the relevant Directives (Capital Requirements~~Second Banking~~

[15] This was discussed at the Journal of Financial Regulation 2016 Annual Conference in Hong Kong.
[16] See Schoenmaker and Véron (2016).

Directive and Markets in Financial Instruments Directive) give the relevant ~~European~~ supervisors in the EU (in this case the Prudential Regulatory Authority and the Financial Conduct Authority in the UK) supervisory powers over the London-based European operations of the US investment banks. If the US investment were to move part of their 'passporting' business to another capital in the euro-area after Brexit, the ECB, as prudential banking supervisor, and the respective national securities supervisor would take over the role from the UK supervisors under the same Directives. The relevant supervisors cooperate in the global supervisory colleges for the US investment banks. However, the lack of binding rules for cooperation between national supervisors (the US and UK authorities at present) has not been solved.

Thirdly, the large corporates could take precautions themselves. For the bigger financing operations, a corporate typically hires a banking syndicate, which is a group of investment banks that jointly underwrite and distribute a new security offering, or jointly lend money to the corporate. The European corporates are well advised to include at least one (large) European investment bank in this syndicate, also in good times when they do not need them. That could help them in bad times, when US banks might be reluctant for whatever reason (including more detached decision-making). The involvement of a (local) European investment bank in the syndicate is not only useful for loyalty but also information reasons. Because of their local roots, the European banks have an information advantage over their US peers, which keep offices in New York and London. The practice of giving a European investment bank at least one place in further US dominated banking syndicates could help to avoid complete dependence on the whims of the big US investment banks, and their political bosses.

Finally, as the underlying financial architecture for banking union and capital markets union is still under construction, we do not expect big changes in the European financial landscape in the short term. If, however, further steps are taken to complete banking union as suggested in the Five Presidents report (2015), including European Deposit Insurance with a fiscal backstop by the European Stability Mechanism, a truly European banking system might emerge with strong regional, and potentially global, players. But that is only guessing. In a completed banking union, European institutions, like the ECB and an expanded Single Resolution and Deposit Insurance Board, would govern the banks, which then would *de facto* move from the country to the banking union level. That would be similar to the US, where the Federal Reserve and the FDIC are responsible for the US banks and absorb shocks at the federal rather than the state level.[17]

[17] See Gros and Schoenmaker (2014).

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Annex – Table 1. Market share of investment banks in EMEA (Europe, Middle East and Africa) investment banking (in %)

Investment bank	Region	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
1. JP Morgan	US	6.5	7.0	6.4	8.5	8.7	7.9	6.8	7.9	7.3	7.5	7.6
2. Deutsche Bank	Europe	6.2	7.6	7.0	6.9	7.1	7.4	7.3	7.8	7.8	7.6	6.0
3. Citigroup	US	8.1	8.1	7.7	5.9	6.6	5.1	5.2	5.9	6.2	6.4	6.7
4. Goldman Sachs	US	4.8	4.7	5.1	5.2	4.9	4.6	5.1	5.3	5.9	5.4	5.9
5. BankofAmerica Merrill Lynch	US	4.4	6.9	7.1	6.5	6.0	5.6	4.8	5.1	5.2	5.8	6.8
6. Barclays	Europe	6.8	7.2	6.9	6.9	7.1	7.6	6.8	6.7	6.7	6.0	6.4
7. Morgan Stanley	US	4.5	5.1	5.3	5.0	5.4	4.5	4.2	4.7	5.1	4.9	5.1
8. BNP Paribas	Europe	5.4	5.0	5.2	5.5	5.5	5.0	5.7	4.5	5.2	4.7	4.4
9. Credit Suisse	Swiss	2.3	3.8	3.7	3.8	4.5	4.6	3.7	3.6	3.8	3.7	3.5
10. HSBC Holdings	Europe	4.4	4.0	3.0	4.4	5.3	5.0	5.2	5.0	4.6	5.0	5.4
11. UBS	Swiss	2.2	3.9	4.4	4.2	3.8	4.6	4.0	3.5	1.9	2.1	2.3
12. RBS	Europe	5.3	7.7	8.5	5.7	4.7	4.2	3.7	3.1	2.8	2.5	1.5
13. Societe Generale	Europe	3.5	3.1	2.6	2.7	3.3	3.0	3.4	2.5	2.8	2.8	2.6
14. Credit Agricole CIB	Europe	3.5	2.7	2.4	3.0	2.7	2.6	3.2	2.6	2.4	2.7	2.5
15. Rothschild	Europe	1.7	1.1	1.3	1.3	0.5	0.7	0.9	1.0	0.7	0.6	1.0
16. Nomura	Japan	1.8	1.3	1.7	1.8	0.1	0.9	1.3	1.5	1.3	1.1	1.1
17. Lazard	US	0.7	0.6	0.5	0.8	0.8	0.9	0.8	0.7	0.5	0.8	0.9
18. UniCredit	Europe	2.0	1.3	1.5	1.6	1.8	2.0	2.0	2.3	2.3	2.1	1.9
19. Commerzbank	Europe	2.4	2.9	2.2	1.2	1.6	1.1	1.3	1.1	1.2	1.3	1.1
20. Natixis	Europe	1.2	1.5	1.1	1.1	1.2	1.5	1.8	1.6	1.4	1.6	1.4
Total top 20		77.7	85.6	83.6	82.0	81.8	78.7	77.2	76.4	75.1	74.6	74.0
Share US banks	US	37.2	37.9	38.5	38.9	39.7	36.3	34.7	38.7	40.2	41.2	44.6
Share European banks	Europe	54.7	51.6	49.8	49.2	50.0	50.8	53.7	50.1	50.5	49.6	46.0
Share Swiss banks	Swiss	5.8	9.0	9.7	9.8	10.1	11.7	10.0	9.2	7.6	7.8	7.8
Share Japanese banks	Japan	2.3	1.5	2.1	2.1	0.2	1.1	1.6	1.9	1.8	1.5	1.5
Total shares		100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	
	100.0											

Source: Bruegel calculations based on Thomson Reuters. Note: The selection and ranking of the top 20 investment banks in EMEA is based on the 11-year average market share across all investment banks.

Table 2. Segmentation of turnover of US investment banks across Europe in 2014

Country	BAML	Citigroup	Goldman Sachs	JP Morgan	Morgan Stanley	Grand Total
Belgium	0.00%	0.00%	0.00%	0.28%	0.00%	0.08%
Denmark	0.00%	0.00%	0.00%	0.25%	0.00%	0.07%
France	0.01%	2.41%	0.00%	0.54%	3.86%	1.12%
Germany	1.02%	9.79%	0.70%	2.49%	0.06%	2.19%
Greece	0.00%	0.00%	0.00%	0.00%	0.04%	0.01%
Ireland	1.72%	0.47%	0.03%	1.87%	0.00%	0.92%
Italy	0.37%	0.64%	0.56%	1.36%	0.98%	0.82%
Luxembourg	0.00%	0.00%	0.02%	4.66%	0.02%	1.27%
Netherlands	0.30%	0.00%	0.14%	0.00%	0.31%	0.15%
Poland	0.00%	0.00%	0.06%	0.00%	0.10%	0.03%
Spain	0.00%	1.14%	0.92%	0.50%	0.21%	0.51%
Sweden	0.12%	0.45%	0.04%	0.25%	0.00%	0.16%
United Kingdom	95.78%	84.62%	96.59%	87.31%	93.14%	91.91%
Other EMEA non EU	0.68%	0.48%	0.95%	0.48%	1.29%	0.77%
Total EMEA	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Bruegel calculations based on country-by-country (CBC) reports of the five US investment banks

Note: The data refer to the investment banking activities in Europe, Middle East and Africa (EMEA).

Table 3. Segmentation of employees of US investment banks across Europe in 2014

Country	BAML	Citigroup	Goldman Sachs	JP Morgan	Morgan Stanley	Grand Total
Belgium	0.00%	0.00%	0.00%	0.13%	0.00%	0.02%
Denmark	0.00%	0.00%	0.00%	0.42%	0.00%	0.07%
France	0.00%	1.70%	0.00%	0.27%	2.12%	0.97%
Germany	1.19%	6.48%	0.72%	6.39%	0.12%	2.62%
Greece	0.00%	0.00%	0.00%	0.00%	0.02%	0.00%
Ireland	9.52%	0.32%	0.04%	9.33%	0.00%	3.34%
Italy	0.99%	0.92%	0.45%	2.17%	1.66%	1.08%
Luxembourg	0.00%	0.00%	0.00%	9.16%	0.31%	1.62%
Netherlands	0.17%	0.00%	0.09%	0.00%	0.12%	0.18%
Poland	0.00%	0.00%	0.54%	0.00%	0.10%	0.13%
Spain	0.00%	2.11%	0.43%	1.00%	0.00%	0.54%
Sweden	0.09%	1.07%	0.07%	0.46%	0.00%	0.26%
United Kingdom	87.06%	83.84%	96.68%	69.78%	94.19%	87.95%
Other EMEA non EU	0.97%	3.57%	0.99%	0.88%	1.36%	1.22%
Total EMEA	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Bruegel calculations based on country-by-country (CBC) reports of the five US investment banks.
Note: The data refer to the investment banking activities in Europe, Middle East and Africa (EMEA).