***Known evil or unknown good?***

*The international banking system after Lehman Brothers*[[1]](#footnote-1)

by Ugo Marani

In September 2008, Lehman Brothers investment bank filed for bankruptcy protection, setting in motion the most sensational bankruptcy in modern capitalism and what would become the largest bailout in history.

With some variation in critiques and emphasis, these events have been reconstructed in all of their infamous glory in an immense body of literature, which has detailed the *perpetrators* (the banking and financial system), the *means* (financial derivatives) and the offending *conduct* (business opacity). Ten years later, public indignation and painstaking scrutiny seem to have given way to a depressing return to traditional mores of economic research. What we need instead is for the analysis of the past decade to help us understand how much has really changed and how much has stayed the same.

Our reflection should focus on international financial integration, in our case the tendency of the largest investment banks to embrace cross-border banking, given that the globalization of the banking system was one of the most conspicuous causes of the 2008 meltdown.

At that time, public financial assistance for banks—in amounts ranging from 5% of U.S. GDP to 40% of Irish GDP—allowed an almost immediate recovery of "traditional" banking. Let's not forget that this was an unprecedented rescue operation: between 2008 and 2013, 45 billion dollars was given out in direct government aid. It is only logical that as a result of such massive intervention, the big international players are much the same as they were pre-crisis. However, the consistent rankings conceal profound changes in the way the international financial markets are now integrated, a complete overhaul of country quotas, the rise of latecomers from other nations, different trends in portfolio management, and new ways of avoiding transparency.

The most striking aspect is the undeniable contraction of European global banking after a phase of constant growth: from 2000 to 2007 European banks’ assets abroad nearly quadrupled, making them the most globalized in the world, while from 2007 to 2015 they shrank by 45%.

The repercussions of the crisis can be guessed: Dutch, French and German banks, for example, were waist deep in the Spanish real estate bubble, while Austrian banks had expanded too far into Eastern Europe and Central Asia and Italian banks were mired in Turkey. The experience in Europe, however, does not imply that the age of cross-border banking is on the wane. In fact, foreign investment as a percentage of GDP has been roughly the same since 2007. What is changing are the instruments and the players, against one consistent backdrop.

That backdrop is the dominance of the major American investment banks in a world where, with Barclays, Credit Suisse, Deutsche Bank and UBS all grown smaller, the narrow circle of bulge-bracket banks is restricted to the big five of Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup and Bank of America Merrill Lynch.

In the decade from 2005 to 2015, the market share of European banks decreased by more than eight points, while their U.S. counterparts gained virtually the same amount. U.S. banks increased their share of the European market thanks in part to the hub-and-spoke model, whereby London continues to function as a hub and the spokes extend toward Frankfurt, Dublin and other major financial centres.

The watershed moment for international banking was the emergence of banks from Canada, Japan, Russia and China, which blatantly fattened their portfolios of foreign assets. The new troupe of players coincided with a change in the kinds of assets acquired abroad: debt securities and outright loans were gradually replaced by equities and direct investments, in an effort to pursue investments that were perhaps less volatile but certainly less dependent on the default risk of the business and/or the company "bought out."

Ten years since the collapse of the financial system it is difficult, and maybe premature, to judge to what extent the big international banks have changed their architecture and how the lesson has affected their behaviour. Radical change overlaps with no change at all, and a more thorough reckoning will likely take time.

A few aspects seem inarguable, however, and also downright paradoxical. First of all, the large investment banks that had such a hand in the 2008 collapse are the very ones still at the core of international banking; in fact, unmistakably, their international capital flows are mightier than ever. Next, the United States, where the crisis had its core and whose Troubled Asset Relief Program was the largest buyout of toxic securities on record, is back to billing itself as the worldwide capital of private placement, M&A, and direct investment abroad. Conversely, in the international hierarchy, the role of European banks has been undermined by new countries with China in the lead. Through a consolidation process that has narrowed the strategic horizon to their own continent, these banks appear less able to follow the model of risk and internationalization which, with apparent mastery, they had learned from their American counterparts in the first ten years of the new millennium.

Obviously, these statements should be put in perspective. European banks still have a more than respectable presence in the transcontinental markets; some countries, like France with its ever-dynamic BNP Paribas, Crédit Agricole Group and Société Générale, have strategies and ambitions that go beyond national borders while fragile institutions like Deutsche Bank insist, thanks to Germany's role in the eurozone, on maintaining a risky asset mix.

However, lest the hierarchy were ever in doubt, all trends suggest that the large continental banks still play an ancillary role. Financial globalization is alive and well, evolving and adapting—in a dialectical relationship with insipid governance rules—to the limits imposed by financial stability. And anyone who might think "systemic risk" is at least partially in the rearview mirror would be seriously underestimating the danger: change doesn't happen overnight, especially in rereading the assessments of major investment bank CEOs. For example: derivatives are no faint memory in big banks' asset management portfolios: as of 2015, they made up 18.6% of assets at JPMorgan Chase, 21.1% at Citigroup, 59.1% at Deutsche Bank, 39.1% at Barclays and 47.7% at BNP Paribas. By no stretch of the imagination have big banks in the U.S. and elsewhere become "safer" in the wake of the crisis; in fact, a bit of in-depth analysis suggests they are riskier than ever.

Since the meltdown of 2008, then, when world finance appeared to have reached a deadlock, the international banking system has showed a resilience that seemed impossible a decade ago. This ability to respond to such a traumatic event should probably be traced to the direct and indirect government aid that the financial industry enjoyed during the following seven years. But whether this was more transparent as in the United States or hypocritically self-righteous as in the Europe of fiscal austerity, resilience is its own motivation; financial governance has not changed a single rule of the game.

It's true that European banks have become more parochial, more biased towards business on the Continent; that China's unique financial system is vying for their place; and that the large American banks are shifting their international portfolios in the direction of less risky (and less profitable) assets. Nothing, however, suggests that big banks are developing a calling for longer-term profits, less speculative behaviour and fewer excesses in the derivatives market.

Paradoxically, the uncertainty felt by the markets in the wake of the crisis may be regarded as another source of speculation. Perhaps the regulator, when arranging for the bailout, the recapitalization of banks in default, should have considered the fact that the more uncertain the future, the greater the impetus to wager not on the most beautiful woman but on the woman the market will find to be most beautiful tomorrow. But the truth (or rather, the paradox) is that our regulators are well aware of the long-established relationships between uncertainty, expectations and speculation. We might well conclude that in their *preference function*, a known evil is preferable to an unknown good.

1. This is an abridged version of a longer work currently in press. [↑](#footnote-ref-1)