More Banks versus the People

Part 4 - A journey into the vice-ridden world of banking

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“As the Economist put it at year-end 2006, ‘having grown at an annual rate of 3.2% per head since 2000, the world economy is over halfway towards notching up its best decade ever. If it keeps going at this clip, it will beat both the supposedly idyllic 1950s and the 1960s. Market capitalism, the engine that runs most of the world economy, seems to be doing its job well.’” [1]

Contents

The primary objective of the world's leaders is to avoid another banking and financial crash that could be worse than the one in September 2008. [2]

As we saw in the first three parts of this series, the big central banks (ECB, Bank of England, US Federal Reserve, and National Bank of Switzerland) have prevented the bankruptcy and collapse of many private banks by lending them massive sums. [3] Without this unlimited line of credit, a large number of banks would have had to suspend payments. Central banks have loaned more than 20 trillion dollars to private banks since 2007. In the EU alone, the loans given to private banks by public administrations go far beyond the unlimited credit doled out at very favourable interest rates. Guarantees must also be put into the balance, which amount to 1.174 trillion euros (9.3% of EU GDP) [4], for the period between October 2008 and December 2011, and bank recapitalisations to the tune of €442 billion (3.5% of EU GDP).

Also to be considered are:

- the decrease in tax revenues, because banks declared losses, which enabled them to avoid paying taxes for several years, even when they were making a profit; [5]
- the decision not to take legal action against banks for financial offences in spite of the damage they have inflicted on society; [6]
- the unwillingness to apply any binding or disciplinary measures on financial institutions in order to prevent another banking or financial crisis. [7]

What is more, the eurozone, the States, and the European commission maintain the judicial framework that gives the private financial sector a monopoly in terms of lending money to the public sector. Yet, the eurozone private banks' principal source of funding at low interest rates (between 0.75% and 1%) is the ECB and the central banks of eurozone countries (which constitute the Eurosystem). These are the funds that are lent to the peripheral EU countries (Greece, Ireland, Italy, Portugal, Spain, and the East European eurozone countries) at exorbitant rates (between 4.5% and 10% or more). From a legal and moral point of view, this is doubly condemnable: the banks are guilty of abusive practises and unjust enrichment (abusive because of the usury rates). In Part 7 of this series, we will look at other crimes and offences committed by banks, which should cancel the debts these banks are trying to collect. The people and the corporations that are responsible should be forced to pay heavy fines, perform community service, have their personal freedom restricted, or be banned from exercising a financial or banking profession.

It would be naive to imagine that banks will take advantage of public generosity to adopt careful management practices for the funds that States allocate to them or that people deposit in their accounts. This is one of the points analysed in the following pages.

Crises are part of Capitalism’s metabolism

A crisis in the capitalist system is a kind of wake up call: speculative bubbles burst, the price of assets [8] moves back towards their real value; the least profitable corporations go bankrupt, and capital is destroyed [9]. Crises are in a way part of Capitalism’s metabolic system.

However, interventions by public authorities, who cater to demands made by Presidents of large corporations, have made it impossible to “clean up” or purge the Capitalist system. There are millions and millions of victims among the 99%, while those responsible for the crisis have not really put things back in order. Very few major corporations have gone bankrupt, the banks have not cleaned up their accounts, and new speculative bubbles have formed or are forming.

The small number of bank failures can be attributed to the aid provided by the ECB and EU governments. Member states considered that the banks were too big to fail. In the EU, only 7 small or medium-size banks have been liquidated: 4 Danish, 1 Finnish-Luxemburgish, 1 Irish, and 1 British [10]

Unless there is a radical shift towards greater social justice, the crisis is going to continue for many more years due to the following factors: current government policy favours the interests of major private corporations and is attacking the social and economic rights of people everywhere; [11] weak government and market demand; speculative bubbles persist; unprofitable and even insolvent corporations are being kept alive.

It is for these reasons that it is important to better understand how banks function. We need to open their books, and audit the budgets of the public authorities that support them, shed light on their activities, and identify what is behind their actions. This analysis will show that the part of public debt that is the direct or indirect result of the banking crisis and bank bailouts is illegitimate. [12] This debt did not serve the general interest. It simply allowed the banks to have their cake and eat it too, while continuing the same disastrous activities. This public debt is the pretext cited by government leaders around the world for attacking the economic, social, and political rights of people.

However, a different conclusion is in order: given their importance and the devastating effect their bad management can have on the economy, banks must be redefined as public services. The work banks do (as an entity enabling people to save money and take out loans) is far too serious to be entrusted to private bankers, who by definition seek to maximise the profits of a handful of private owners (the 1%, as the Occupy Wall Street movement called them). Given that they use public funds, benefit from government guarantees, and are supposed to provide a basic fundamental service to society, banks should become a public service.

This alternative conclusion leads me to make two radical propositions. First, the cancellation/repudiation of illegitimate public debt and the launch of a new government borrowing policy promoting social justice, better living conditions, and the restoration of the major ecological balances. Second, the banking sector should be socialised, placed under citizen control, and be subjected to public service rules and regulations, [13] and the revenues generated must be used for the common good. Other measures are also necessary, such as putting an end to austerity policies. [14]

The secret mission of banks: maximum Return on Equity (ROE)

If we really want to understand how the major shareholders and Directors believe their banks should operate, where their motivations come from, and their behaviour as capitalist corporations, it is important to take into consideration the scramble for Return on Equity.

The notion of Return on Equity (ROE) is indeed a key to understanding their mindset. From the 1990s to the beginning of the crisis in 2007-2008, there has been a mad race for maximum ROE: 15% was common, but some banks were getting 25 to 30%. In 2007, ROE stood at 15% in the eurozone, 17% in the United Kingdom, and 19% in the USA. [15] Let us take for example two major US banks: Goldman Sachs and Morgan Stanley (the 5th and 6th largest banks in the country). They both posted a 30% ROE in 1999-2000 until the internet bubble burst and Enron went bankrupt in 2001.

From 2001 to 2004, the shareholders of these two banks had to content themselves with an ROE between 12 and 16%. Thanks to the all-out support policy for banks and big business implemented by the Fed and the Bush administration (with Henry Paulson, the former CEO of Goldman Sachs, working as the Secretary of the Treasury), Goldman Sachs's ROE again reached 30% in 2006-2007, while Morgan Stanley's shot back up to 25% in 2006, before falling again in 2007. Goldman Sachs advised its clients to purchase structured subprime products (the famous CDOs – Collateral Debt Obligations), while at the same time speculating that they would drop as of 2007. That is why it could post a 30% ROE at the height of the banking crisis, while its chief competitors Bear Stearns, Merrill Lynch, and Lehman Brothers were beginning a descent into hell. The SEC (Securities and Exchange Commission, the authority controlling banks in the United States) ran an investigation into Goldman Sachs activities at that time, and gave the bank a heavy fine. Then in 2008, Goldman Sachs's ROE fell to 10% and Morgan Stanley's to 2%. In 2009, Goldman's ROE went up to 20%, and Morgan Stanley's was 10% in 2010. Finally, in 2011, the two banks' ROE dropped back to 5%. [16]

Generally speaking, a bank's equity is made up of the capital put up by its shareholders [17] 25 years ago, this equity represented 8% of the bank's assets. For example, for a bank that had assets worth 100 billion euros (broken down into household loans, corporate loans, government bonds, corporate bonds, commissions on corporate mergers, and initial public offerings (IPOs)), its capital equity would have been 8 billion euros.

In that case, to achieve a 15% ROE, net profit must be €1.2 billion (15% of 8 billion). It seems easy to obtain such net profit with assets that amount to €100 billion, as they represent only 1.2% of that amount.

The exponential inflation of bank assets to increase ROE

The offer of new structured financial products or derivatives developed very rapidly from the middle of the 1990s. The big banks wanted their part of this buoyant and expanding market, knowing that if they were not well placed, they would be overtaken, and eventually taken over by their competitors. The profits on these products are relatively small, usually around 1%. If the shareholders are pushing for a 'Return on Equity' between 20% and 30%, the directors are under pressure to greatly inflate their assets. In the previously mentioned example, the assets were tripled in twelve years to €300 billion, while the capital remained stable at €8 billion or 2.66% of the assets. This growth was funded by borrowing.

_Leverage

The bank concerned had used leverage, which consists in increasing its borrowing to increase the profitability of its own resources. [18]The leverage is 36:1 (the debt is equal to 36 times the capital). As the competition between the big banks on the derivatives markets has increased over the years, the profitability of these products has decreased: in some cases it is no more than 0.1%. To maintain the ROE at 30% while the profitability of derivatives is reduced, the banks chose to increase their assets, notably in the derivatives domain, and by creating structured high profit products very much based on sub-prime contracts. In compliance with part 6 of the Basel 2 accord, they are not allowed to have capital inferior to 2.5% of their total assets. To obtain revenues and maintain high ROE, they turn to off-balance sheet methods. They create non banking companies, consequently not subject to banking regulations and controls, specialising in the derivatives markets. In 2007, the sub-prime market crashed. The banks and their specialised offshoots suffered losses, sometimes greater than their capital. If the bank in our example that uses a 36:1 leverage effect has a 3% drop in the value of its gross assets, its net assets are swallowed up. Either it goes bankrupt, gets taken over by another bank, is 'nationalised', calls on the State for a bail-out, or tries to cover up the losses by manipulating the accounts until better times arrive and profits return.

These different cases actually occurred. In the US, 400 small and medium-size banks went bankrupt alongside Lehman Bros, which was the 4th largest commercial bank. In Belgium, Fortis, the country's largest bank was taken over by BNP-Paribas in 2008. Another US bank, Merrill Lynch, was taken over by Bank of America, and Bear Stearns was bought by JP Morgan.

_The case of Northern Rock

In the UK, Northern Rock, which was originally a building society [19], changed its legal structure in 1997, and took on an aggressive real estate strategy. Between 1997 and its downfall in 2007, it grew by 23% a year to become the 5th British mortgage bank with 90% of its loans in real estate. In order to finance its growth, Northern Rock isolated its deposits and became dependant on short-term borrowing. Leverage effects were used to the full, going beyond 90:1. On 13 September 2007, Northern appealed to the Bank of England, depositors panicked, and a bank run on Northern Rock took place. Yet, it was not the bank run that caused the bank's downfall; rather it was the decision by major private lenders, some months before, to cut off the funds from one day to the next that chimed the death knell for Northern Rock. The bank was nationalised in February 2008. [20]

_Deutsche Bank charged with deceit by former employees

A much less mediatised case concerns Deutsche Bank (DB), the biggest bank in the world in terms of overall assets (see above). It illustrates a situation in which a bank covers up its losses so as to avoid the government stepping in and investors turning away, which would send share values plummeting. The events occurred in 2009. The three former employees who exposed the facts to the SEC (Security and Exchange Commission) in 2010-2011 claim that Deutsche Bank had concealed a $12 billion loss on the US derivatives market. If Deutsche Bank had acknowledged such losses in its 2009 balance sheet, its capital would have been reduced by 25%, which would have made it compulsory for the German government to bail it out (since it required the equity of German banks to amount to 8% of their assets). Instead of acknowledging any loss, the bank launched a major campaign to boost stock market share value. It announced €1.8 billion profit before tax for the first quarter in 2009. DB share value increased from €16 in January 2009 to €39 at the end of April 2009. Each of the three employees exposed the deception without knowing about the other two. Eric Ben-Artzi, who was risk manager with DB, was fired three days after he had told the SEC about the deceit. He initiated a lawsuit against DB for unfair dismissal. The second complainant, Mattew Simpson, voluntarily left DB with $900,000 in compensation money. The third complainant wishes to remain anonymous. The SEC is most embarrassed by this scandal, because Robert Khuzami, currently Enforcement Director at the SEC, was working as General Counsel for the Americas with Deutsche Bank from 2004 to 2009 when the cover-up occurred. Richard Walker, who is currently general counsel of corporate and investment banking at Deutsche Bank, was Enforcement director at the SEC for ten years. This shows that while Goldman Sachs has indeed a most pernicious influence, other major banks play a crucial role in the decisions made by governments and control authorities both in the US and in Europe.

Evolution in bank assets and activities since the 1990s

In the theoretical case presented above, it is claimed that the balance sheet values of banks, both their liabilities (debts) and their assets (property and bank products generating revenues), increased significantly between the 1990s and the outbreak of the crisis in 2007-2008. The IMF reports that global bank assets increased by about 140% from 2002 to 2007, rising from $40to $97 trillion. They further increased from 2007 to 2011, reaching $105 trillion. While bankers and governments keep repeating that banks have cleaned up their assets and gone on a strict diet, this is not at all true. Only very recently has the volume of assets started to decrease, and in a marginal way. The IMF reports that from the 3rd quarter of 2011 and the 2nd quarter of 2012, the reduction of assets in European banks (outside derivatives) amounted to only 2%.

The Liikanen report, named after the chairman of the group of experts appointed by the EU Commissioner for Internal Market and Services Michel Barnier to make propositions concerning structural reforms to the EU banking sector, provides extremely interesting information on EU banks.
It shows that in France the assets of Société Générale (8th largest European bank, 3rd biggest French bank) increased from €410 billion in 1999 (when the euro was launched) to nearly €1.2 trillion in 2008 (an increase of close to 300% over a decade). In 2010, assets were still close to €1.2 trillion. In Germany, the assets of Commerzbank (15th largest European bank, 2nd biggest German bank) went from €380 to €850 billion between 1999 and 2009.

If we consider the whole European banking sector, assets went from €25 trillion in 2001 to €43 trillion in 2008 (3.5 times the EU’s GDP)! Banks debt followed the same trend.

The increase in bank assets has relied on more borrowing, in some cases in a steep rise in mortgages and for most major banks on a dramatic increase in trading activities that include derivatives and structured securities. The issue of Asset Backed Securities was massively monopolized by US banks, but European banks were also keen to participate. They bought those ABS thanks to short-term loans, while the products bought had much later maturity, thus using the leverage effect. To cover the risks, banks would buy credit derivatives and other kinds of derivatives meant to protect them against risks related to currency exchange, interest rates, and so on. In September 2008, the bankruptcy of Lehman Brothers and the bailout of AIG (the biggest insurance company in the world) showed that those who issued derivatives could not cope with the risks they were meant to cover. The total volume of derivatives literally exploded, from $100 trillion in 1998 to $750 trillion in 2007.

The growth of European banks did not rely on their clients’ deposits (which increased only modestly), but on their debts on the interbank market, with the ECB, or with Money Market Funds (MMFs).

What are Money Market Funds?

MMFs are financial corporations in the United States and Europe, rarely controlled and subject to few rules. The specialized press considers them to be closely akin to shadow banking. [21]

The Obama administration is considering creating regulations, because if an MMF goes bankrupt, it may be necessary to bail it out with public money. A worrying situation given the vast quantities of money they handle, and the sharp drop in their profitability since 2008. In the United States, they held $2.7 trillion in 2012, a significant drop from the $3.8 trillion in 2008. MMFs lend on a very short-term day to day basis. Created by JP Morgan, the biggest bank in the United States, Prime Money Market Fund is among the largest, worth $115 billion. Wells Fargo the 4th largest bank in the United States has an MMF managing $24 billion. Goldman Sachs the 5th biggest bank controls an MMF worth $25 billion. US banks also operate MMFs in Europe; JP Morgan (€18 billion euros), Black Rock (€11.5 billion), Goldman Sachs (€10 billion), alongside European banks such as BNP Paribas (€7.4 billion), and Deutsche Bank (€11.3 billion). Some MMFs also operate in British pounds. Michel Barnier (European Commissioner for the Internal Market and Services) has also announced that he would like regulations to be imposed on this activity, but this is most likely to remain nothing more than a statement of good intentions. [22]

Bank balance sheets have not been reduced since 2007 – 2008

The authors of the Liikanen report expected that because of the severity of the crisis, the banking sector would be restructured, bank balance sheets reduced, and the weaker firms closed down. This did not happen, the volume of assets have not shrunk since the crisis struck in 2008. [23] It was then €43 trillion and has grown to €45 trillion in 2011. Given that European GDP has slightly decreased, in 2011 the assets (including the debts) of the European banks were equivalent to 370% of European GDP! Between 2007 and 2011 Deutche Bank assets increased by 12.4%, those of HSBC by 22.2%; BNP Paribas + 16%; Credit Agricole + 22%; Barclays + 12%; Santander + 37.1%; Nordea, the principal Swedish Bank + 84.1%; Commerzbank + 7.3%; Intesa + 11.6%, and BBVA + 19.1%. Of the eighteen top ranking European banks, only three have seen their assets decrease: Royal Bank of Scotland -28%; the principal Dutch bank ING -3.33%, and the principal Italian bank Unicredit -9.3%. [24]

Why have banking balance sheets not been reduced?

They have not reduced their balance sheets because no authority has forced them to do so, and they have been well furnished in cash flow by the ECB, the FED, and other institutions. They continue to play heavily on the leverage effect. What is more, in the eurozone, the ECB has been encouraging banks to purchase ever more public bonds.

The European banks are slowly trying to unload part of the toxic assets that clutter their balance sheets. When they sell off toxic products below their purchase price (as indicated in their balance sheets) they must write-down the value of their assets. Of course in doing this, they reduce the whole value of their balance sheet. What they do liquidate is very little compared to the immense volume of their assets, and they hesitate to sell them for the derisory prices they would get. They prefer to wait and see if the price rises. This price rise may never come about, and at the maturity of the contract it will be necessary to make considerable write-downs.

Meanwhile, back in the United States the Fed has purchased a huge amount of toxic assets: about $40 billion per month in 2012. In the eurozone, since the end of 2011 the ECB has accepted toxic assets as collateral for loans. The ECB has decided, since the beginning of December 2011 to ease the eligibility criteria of for guarantees for certain assets such as 'Asset Backed Securities' and 'Credit Claims'. [25] The ECB thus accepts in its own balance sheet part of the toxic assets that private banks are having a hard time trying to unload. [26]

Some details on EU banks [27]

Each of the ten biggest European banks holds €1 trillion in assets:

- 1 is German (Deutche bank, €2.164 trillion in assets which represents 84% of German GDP, 101,000 employees),
- 4 are British – (HSBC, €1.968 trillion , 120% of British GDP, 288,000 employees; Barclays, €1.187 trillion , 114% of British GDP,141,000 employees; Royal Bank of Scotland (RBS), €1.804 billion , 110% of GDP, 147,000 employees; Lloyds Banking group, €1.162 trillion, 70.7% of GDP, 99,000 employees),
- 4 are French – (BNP Paribas, €1.965 trillion, 99.8% of French GDP, 198,000 employees; Credit Agricole, €1.880 trillion, 95.4% of GDP, 162,000 employees; Societe Generale, €1.181 trillion, 60% of GDP, 160,000 employees; BPCE, €1.138 trillion, 58% of GDP 117,000 employees),
- 1 is Spanish (Santander, €1.275 trillion representing 118% of Spanish GDP, 193,000 employees)

Ten years ago, none of the big banks had a volume of assets that was greater than the GDP of their country of origin. In most EU countries, banking concentration has increased. In Belgium, between 1997 and 2010 the five biggest banks increased their market share from 52% to 75%, in France from 40% to 45%, in Greece from 55% to 70%, in Ireland from 40% to 57%, and in Germany from 17% to 33%. [28]

Of the thirty biggest banks in the world in 2011, fifteen were European. Six of these banks were bigger than JP Morgan, the biggest bank in the US. [29] In addition, three European banks are very offensive on the Wall Street Market in particular, and in the US in general: Deutche Bank, Credit Suisse, and Barclays. They control 23% of the US debt market. On the mergers/acquisition market, Credit Suisse, DB and Barclays are in 4th, 5th, and 6th positions just behind Goldman Sachs, JP Morgan, and Morgan Stanley. [30]

_The top twenty European banks eat 50% of the cake

There are 8000 banks in the EU that may be divided in three categories 1) 4000 small co-operative banks having less than one billion euros in assets; 2) those with between one and one hundred billion euros in assets: 3) major banks that have more than €100 billion and up to €2.2 trillion in assets.
The twenty biggest, that is 0.25% of the total number of banks, own 50% of the total assets: more than €23 trillion.

The small banks are generally more solid and do proportionally more domestic and industrially productive lending than the big banks. Because of their smaller size they are equally less risky. Numerous studies show that small cooperative or savings banks are more efficient, reliable, and useful than the big banks. [31]They are more helpful to their clients and are more involved in useful local investments, especially true when local institutions are involved. [32] According to the Liikanen report, Austria, Finland, Germany, and the Netherlands are the European countries where co-operative and savings banks are the most conducive to public utility.

_The major banks are "universal"

The "universal bank" also called "full service financial firm" or "full service investment bank" means a major financial group covering various banking sectors as different as retail banking, commercial and investment banking, and asset management. They are active all over the country and abroad through their foreign branches. The risks here are important, as failures in the hazardous finance and investment sectors of activity may have adverse effects on other sectors within the bank and put the small depositors' savings in danger. This is the case of the biggest European banks.

_The major banks have an appetite for derivatives

According to the ISDA (International Swaps and Derivatives Association), the union of private banks active in derivatives trading, 94% of the world's 500 principal banks are present on the derivatives market (in descending order, derivatives on risks over exchange rates, interest rates, commodities, and CDS); 80% of derivatives are produced and marketed by banks: it's their captive markets. Hedge funds (some of which are bank offshoots) weigh much less than the banks on derivative markets, their assets are worth no more than $2 trillion, which is completely marginal compared to the $100 trillion in the hands of the banks. The overwhelming majority of derivatives trading escapes from any control as it is conducted over the counter.

_Trading is God!

Half of Deutsche Bank's and the Royal Bank of Scotland's assets are used for trading, while the figure is 40% for both BNP Paribas and Barclays.

_What is trading?

Trading is a financial market activity in which banks and other traders take buying or selling positions in stocks and shares, interest rates, currencies, derivatives markets, futures or options on these instruments, commodity futures (including foodstuffs), real estate and others. Trading is clearly a speculative activity based on making gains through short-term price fluctuations largely brought about by traders' actions. The purchasing or selling of the commodities or products are not done to use them, but solely to make profit from the transactions. This activity was the main cause of the food crisis in 2008 – 2009, when the banks and other high rollers suddenly and massively transferred their trading funds away from the ailing real estate markets hit by the subprimes crisis towards commodity futures, [33] especially cereals. [34] The same trading mechanisms were also at the origin of the rocketing oil prices in July 2008, and their sharp drop a few months later. Part of this trading is declared on a bank's balance sheet, the other — often greater — is conducted off-balance sheet on the OTC (over the counter) markets.

Barclays, BNP Paribas, Deutsche Bank, Nordea, Royal Bank of Scotland, and Société Générale are the banks that do the most trading as a proportion of their total business (more than 30% of their assets).

For four of these banks (Barclays, BNP Paribas, Deutsche Bank, and Royal Bank of Scotland), the derivatives they hold represent in notional value (i.e., the risk covered) more than 20 times their assets, [35] and more than 300 times their equity stricto sensu. We must recall that the derivatives market is not regulated and so has no controls! For Royal Bank of Scotland, derivatives represent 30 times their assets, for Deutsche Bank and Barclays 28 times, for BNP Paribas 25, and 7 for BPCE. From 1990 to 2010, the major banks took increasingly bigger risks, in particular by developing trading activities. As a result, the percentage of fixed income (from loans to clients, and government and corporate bonds) decreased in their earnings. For Barclays and Deutsche Bank, between 1993 and 1996, loans represented half of their assets, whereas in 2007-2008, they only made up one tenth of them! Deposits from clients (households, companies, government administrations, and financial institutions) represented less than 30% of the liabilities of BNP Paribas, Deutsche Bank, Barclays, and Societe Generale.

Households and non-financial companies lend more to banks than banks lend to them

In general, banks loan less money to households and non-financial companies than they receive from them in deposits. This can be seen in the following figures concerning the amount households and non-financial companies contributed to the financing of banks (i.e., their debt) in 2011: 41% for Belgium, 23% for France, 28% for the United Kingdom, and 36% for Germany. [36]

By comparison, in their assets, the percentage of loans given to non-financial companies (NFCs) and households was very small: for Belgium, 10% to NFCs and 9% to households; for the United Kingdom, 5% to NFCs and 15% to households; for France, 10% to NFCs and 12% to households; for Germany, 10% to NFCs and 17% to households; for Spain, 23% to NFCs and 22% to households. [37]

Bank loans to households and non-financial companies are a minor part of bank assets

On average, loans by all European banks to households and non-financial companies only represent 28% of their assets; the remainder is made up of other kinds of debt, ABS, and sovereign debt. [38]
However, that does not take account of the hidden activities, their off balance sheet transactions, or the infamous shadow banking system.
The 10 biggest European banks receive the most government aid

Between 2008 and 2011, the 10 biggest European banks received more than half of the €1.620 trillion (13% of GDP in the EU) of public aid disbursed in the form of recapitalisations and guarantees.

The Big Banks work in the shadow economy

As is the case on other continents, the major European banks make their business activities as opaque as possible by setting up a large number of companies. In a significant number of cases, there are more than one thousand different legal entities for a single bank. In addition to making the work of auditors very difficult, most of these entities are based in tax havens in order to pay the least possible amount of taxes, for themselves and their wealthy clients, and to, launder money. [39]

Return on equity

According to the Liikanen report [40], in 2011, equity capital represented only 2 to 8% of the total assets of the major banks. For Deutsche Bank, they hardly exceeded 2%. For ING and Nordea (Sweden), they were a little less than 4%, while for BNP Paribas, Crédit Agricole, BPCE, Société Générale, and Barclays, they represented about 4%. For the Spanish banks Santander and BBVA, the Italian banks Intesa Sanpaolo and Unicredit, and also for the Belgian bank KBC, they were around 6%. [41]

Let’s do a little practical exercise to get an approximate idea of the return on equity in 2012 of the banks in some key countries. As you do this exercise, you must keep in mind what was explained above in the section “The secret mission of banks.”

The IMF issued a publication on bank profits as a percentage of total assets at the beginning of 2012. These profits were very low, and in some cases (Greece, Ireland) negative :

Greece -0.4%

Ireland -0.8%

Italy 0.4%

Portugal 0.3%

Spain 0.2%

Austria 0.4%

France 0.2%

Germany 0.2%

Netherlands 0.4%

UK 0.0%

Denmark 0.1%

Switzerland 0.2%

Sweden 0.6%

United States 0.8%.

If we limit our analysis to this table, we get the impression that the shareholders of European banks are not very well off. But let's go further, and try to understand their ROE. Let's consider Deutsche Bank, which according to the Liikanen report had €2.164 trillion in assets, basing our analysis on the principle that its profit corresponds to the average amount reported by the IMF for Germany (0.2%). That would mean profits of €4.33 billion. According to the Liikanen report, in 2011 Deutsche Bank's capital equity amounted to 2% of its total assets [42], or €43.3 billion euros. In this case, its ROE works out to be 10%, which is a more faithful representation of true bank profits in these hard times.

Now let's apply the same reasoning to BNP Paribas. Knowing that its assets amounted to €1.965 trillion in 2011, a profit of 0.2% (€3.93 billion) would mean ROE of 5%. Indeed, according to the Liikanen report, in 2011, the capital equity of BNP Paribas represented about 4% of its assets (around €78.6 billion).

The CADTM would be very thankful if readers who have access to data concerning the ROE of one or several European banks would send us this information at info cadtm.org.

A final point must be emphasised: banks tend to cook their books when it comes to estimating their assets, which is also true of their estimations of their capital equity, and other items on their balance sheets, because the Basel III accords force them to have better capital ratios (see Part 6 of this series).

Conclusion

In order to achieve an alternative solution to the capitalist way of managing the crisis, it is essential to understand the role the banks play and expose their dark side. This will help strengthen the grassroots action of citizens, and in particular the citizens audit initiatives that are under way in Europe (Spain, Greece, Portugal, France, Belgium, Italy…) and elsewhere. [43]

The banks have lost much of their legitimacy; however, they can count on unlimited support from governments and mainstream media. The private banks and governments that promoted the radical financial deregulation that began in the 1980s and 1990s are responsible for the present debacle. The decisions that have been taken are making problems worse and longer-lasting. We are living through a new major crisis of the capitalist system, along with many others such as the food and environmental crises. [44]

The banking crisis alone has entailed huge costs for society and it is not over yet. Luc Laeven and Fabian Valencia, two economists at the IMF, estimate that the drop in the GDP growth attributable to the banking crises for the period 1970-2011 is 33% (23% for the eurozone, 31% for the US). In their opinion, the final cost is likely to be even larger.

The same two authors say that in the advanced economies over the period 1970-2011 the banking crises accounted for 21% of the rise in public debt (20% in the eurozone and 24% in the United States). [45] Even if this is not at all the conclusion reached by Laeven and Valencia, this debt is clearly illegitimate, and we must therefore refuse to pay for it. Besides the need to reject repayment of the debt caused by the crisis and the bank bailout as it is currently being carried out, bank policy has to be met with a radical response. Since banks use public monies, receive State guarantees, and have to provide society with essential basic savings and loan services, the banking sector should be socialized and become a public service.

The fifth part of this series provides an analysis of the weak points of the banks today, and the sixth part will explain why the initiatives taken by governments to regulate banking activities are completely inadequate.

Epilogue: a purely imaginary story

It is not that easy to put oneself in the shoes of a Big Banker, whether it is a major shareholder or an appointed top executive, and to try to understand the way they see their business. The vast majority of people who have a bank account [46] would struggle to even imagine how those who run the very same bank work, how they think, and how they benefit from their activities. Understanding what return on equity (ROE) is in concrete terms is particularly challenging, since many of us cannot even imagine what lies behind the answer to such a question.

Let us try to make things easier to grasp, by comparing a family, like any other family, to the leaders of big banks, who are very few in number.
Let us imagine Mr. and Mrs. Fernandez in Spain in 2007. They are close to their fifties and during 30 years of activity have saved up €100,000 (which they consider to be their capital). They decide to buy a house worth €500,000, which is made up of three apartments. They make a €100,000 down payment (20% of the total price). They plan to live in one of the three apartments, and rent out the other two. They borrow €400,000 to be repaid over 20 years at 5% interest, that is €18,780 a year (the average amount for the first four years of the loan) plus an annual €12,898 to repay the capital (the average amount for the first four years of the loan), that is €31,678to repay each year. Here is what they plan to do: "If we rent out each apartment for €1,000 a month, we will get an annual €10,000 per apartment, i.e., €20,000 in all, allowing for maintenance and other costs. We will have to finance €11,678, which is 117% of the rent we previously had to pay. That means we will have to dedicate a greater share of our income to repay the loan, but in the end, when we are 70, we will be the owners of this house, which will be a source of income, and one day we will leave it to our 3 children."

On the other hand, let us imagine that the same year the Big Bucks Bank also decides to buy the same kind of real estate as the Fernandez couple. The bank buys hundreds of them so as to increase its real estate-related assets in a context of soaring prices. Real property worth €500,000 may be worth €600,000 two years later. It is therefore a good deal. How is the bank going to finance this purchase? Here is the plan: they make a 4% down payment with the bank's own funds, i.e. €20,000. For the remaining €480,000, they take €180,000 from the current accounts of their clients who deposit their salaries and other income there (which represents a kind of interest-free loan by these clients to their banks). To finance the rest (€300,000), they borrow on the interbank market at a 3.26% rate (the average European interbank rate or "Euribor" from 2007 to 2010). In addition to the €20,000 of its own funds that the Big Bucks Bank spends just once, the annual cost of the purchase amounts to €9,780 in interest paid to the other banks. If, like the Fernandezes, the bank rents out the three apartments €1,000 each, allowing for all maintenance costs, it will get about €30,000 every year €9,780 of which will go to paying the interest. The net income comes to €20,220, which is a 101% return on the capital initially invested. As for the return on total investment, i.e., €20,220 on €500,000, it is 4.04% per year.

The difference between these two situations is blindingly obvious. What the banks do to finance the purchase of real estate is very far from the options available to anybody else. In the small and closed world of the big banks (let us not forget that out of the 8,000 banks operating in the EU, the 20 largest own half of the €46,000 billion in assets!), somehow they do not pay back what they borrow, they just pay interest. In fact, for each instalment, they take out a new loan to pay back the previous one. This option is simply unimaginable for the vast majority of people. In addition, as we have observed, they pay little or no interest on the deposits made on currents accounts even though they use the money deposited there. This situation will last as long as the major banks have continuous and cheap access to credit (preferably at a rate below the inflation rate). Of course, if depositors withdraw their money and/or if the different lenders lose confidence and turn off the credit tap; the bank is left in default, since its little game is over. In this case, it is very likely that the public authorities will intervene to bail out the bank if they consider it to be too big to fail.

The imaginary situation described above was set in 2007. Let us take a step forward in time: it is 2013, the real estate bubble has burst in Spain (as well as in Ireland and the United States), which has had devastating consequences. Hundreds of thousands workers in the construction industry have lost their jobs, economic activity has slowed down, all the other economic sectors have been impacted, the number of unemployed people has soared [47]. The Fernandezes are unemployed and cannot continue paying the mortgage on their €400,000 loan. The Miserly Bank repossesses their house; [48] the Fernandezes end up homeless, and must ask their children to put them up. The bank sells the house, and receives €300,000, since prices have plummeted. The Fernandezes had paid €75,120 in interest over four years, and paid off €51,591 of the capital borrowed [49], bringing the outstanding capital to €348,409. According to the Spanish law, the Miserly Bank demands that the Fernandezes, who are jobless and homeless, pay back €48,409 (i.e., the outstanding capital after a payment of €300,000 coming from the sale of the property).

Let us now have a look at what is going on for the Big Bucks Bank, which had bought similar real estate. In 2013, it can carry on its purchases with a change in its funding profile since the other banks won't lend it money (the banks distrust each other because of the bad debt that many of them have). Fortunately, the public authorities are ready to help the Big Bucks Bank and the other banks. The ECB lends them money at a rate well below the inflation rate. A real blessing for bankers.

What does the Big Bucks Bank do? It buys the Fernandez's house from Miserly Bank for €300,000. To do that, it invests €18,000 of its equity capital (that is 6% of the price of the house), withdraws €132,000 from its clients' deposits, and borrows €100,000 short term from the ECB at 0.75%. The annual interest to be paid by the bank is €1,375. The bank rents out the three apartments at the same price, which means an income of €30,000 minus €1,375 of interest (€28,625). The return on equity (ROE) is 159%, the profit on the total investment, 9.5%.

All of this is of course pure fantasy. But is it really that far from reality?

Part 5: The Banks, Fragile Giants

"In order to facilitate the financing, insuring, and timeliness of all that trade, the volume of cross-border transactions in financial instruments has had to rise even faster than the trade itself. Wholly new forms of finance had to be invented or developed, credit derivatives, asset-backed securities, oil futures, and the like all make the world's trading system function far more efficiently.

In many respects, the apparent stability of our global trade and financial system is a reaffirmation of the simple, time-tested principle promulgated by Adam Smith in 1776: Individuals trading freely with one another, following their own self-interest leads to a growing, stable economy." Alan Greenspan [50]

The financial innovations presented as a panacea by Alan Greenspan have been a big flop, causing very serious economic and social damage. At the same time, the dictatorship of the markets and the ukases of the European troika have been infringing on the democratic rights of citizens everywhere. European treaties and the policies applied by successive governments have progressively chipped away at the peoples' hard-won democratic rights: the legislative power has been increasingly dominated by the executive, the European parliament is a front piece for the European Commission, and there is less and less respect for what the electors try to say. Meanwhile, leaders hide behind the European treaties and repeat the old Thatcherite refrain: TINA (there is no alternative), to justify austerity and debt repayment. At the same time, they have been doing as much as possible to defy the economic and social rights conquered during the 20th century, on the one hand.(see Part 3 of this series); and, on the other hand, to prevent a new banking crisis from erupting. However, no seriously restrictive measures have been taken to impose a new discipline on banks and other financial institutions. The banks have not cleaned up their accounts since 2007-2008. Worse yet, they have been very active in creating new bubbles and new structured financial products.

In this fifth part of the series, [51] we look at how the banks have been bending over backwards to fund their activities, their almost total dependence on public assistance, the speculative bubbles that are in gestation, speculative financial innovations, the disastrous effects of the present banking system particularly in creating food crises, as well as the new risks that the modus operandi of banks has been creating for people. [52]

Medium- and long-term financing problems

We will first have a look at the financing side of bank operations, (i.e., bank liabilities), where banks are encountering big problems. Institutional investors (insurance companies, pension funds, other banks, and sovereign wealth funds among others) no longer have confidence in banks, and hesitate to buy their covered bonds issued in the hope of finding stable long-term financing. Even if some banks like France's two biggest, BNP Paribas and Societe Generale or Spain's second biggest bank BBVA, have found buyers for their bonds, the volumes issued in 2012 remain as low as in the previous years. According to the Financial Times, this might even be the worst year since 2002. [53]

As the banks cannot find sufficient long-term funding on the financial markets, they are vitally dependant on the 3-year ECB loans totalling €1 trillion at 1%, [54] and generally the liquidities made available by the central banks of the industrialised countries (particularly by the US Federal Reserve Bank, the ECB, Bank of England, National Bank of Switzerland, and the BoJ (Japanese Central Bank)).

Short-term financing problems

Much of their financing, other than deposit and savings accounts, which show no growth because of the crisis, must be found on the short-term market. According to the Liikanen report, the big European banks need €7 trillion from day to day. [55] The volume of banks' short term debt increased significantly between 1998 and 2007, from €1.5 to €6 trillion, while from 2010 to 2012, it remained at €7 trillion! Where do banks find this short-term money? It is no longer, or hardly, available on the interbank markets, because the banks are too wary to lend each other money. They are thus dependent on Money Market Funds (MMFs) which have up to $2.7 trillion available for day-to-day trading depending on how the winds of crisis are blowing in Europe. [56] MMFs shut off the flow in June 2011, and reopen it when the ECB lent €1 trillion. [