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Bank earnings volatility in the UK: Does size matter? A comparison between commercial and investment banks

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ABSTRACT

During the global financial crisis, the issue of banks' size and especially whether banks could be 'too big to fail' (TBTF) was raised. Our study focuses on the impact of size on bank earnings volatility in the UK, which is among the most open financial systems in the world. This study analyzes commercial and investment banks. For the model specification, we employ panel data to analyze the period from 2000 to 2012. Our analysis indicates a nonlinear relationship between the bank size and earnings volatility of commercial and investment banks.

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1. Introduction

Whether banks can be 'too-big- to fail' (TBTF) has been an issue for decades in discussions of banking regulation. The term was used in 1984 when Continental Illinois, the 7th largest bank in the US, approached insolvency (Völz and Wedow, 2011). To protect Continental's creditors and prevent financial instability, US regulatory authorities provided the bank with a capital rescue package (Morrison, 2012). The term TBTF reflects how regulatory authorities manage financially troubled large banks (Kaufman, 2002), especially systemically important financial institutions (SIFIs). The Financial Stability Board (2010) describes TBTF banking institutions as those whose disorderly failure could cause significant disruption to the functioning of financial markets and the economy as a whole because of their size, importance, complexity and systemic interconnectedness (Abreu and Gulamhussen, 2013). Federal Reserve Chair Bernanke (2010) defined TBTF as follows: *"a too-big-to-fail firm is one whose size, complexity, interconnectedness, and critical functions are such that, should the firm go unexpectedly into liquidation, the rest of the financial system and the economy would face severe adverse consequences."*[1]

During the years preceding the 2007–2009 financial crisis, banks rapidly expanded their balance sheets to increase their profitability. In Iceland, the liabilities of banks reached approximately 9 times GDP by the end of 2007, and in the United Kingdom, these liabilities reached 5.5 times GDP (Demirgüç-Kunt and Huizinga, 2013). The size of banks has increased

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[1] Causes of the Recent Financial and Economic Crisis. Before the Financial Crisis Inquiry Commission, Washington, D.C. September 2, 2010.

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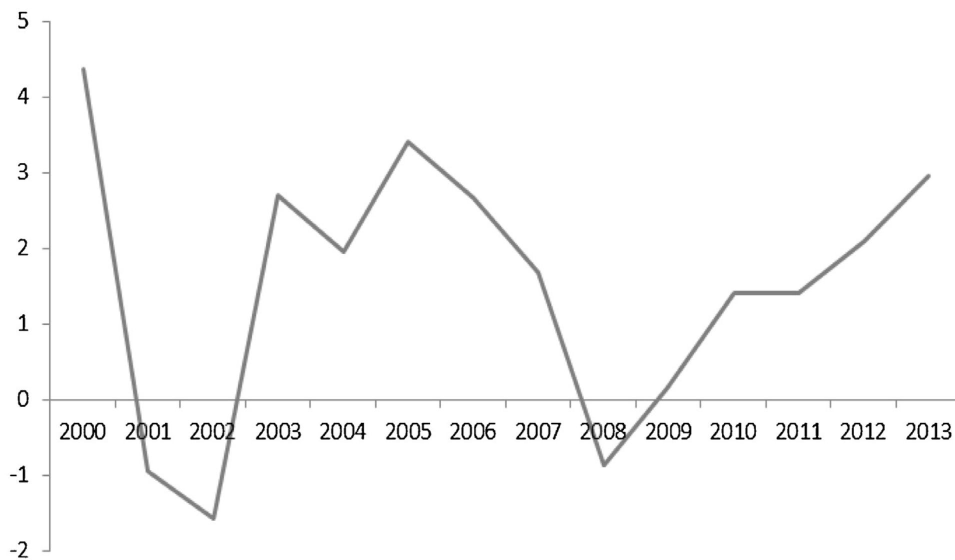

Fig. 1. Average ROAA of UK active banks.

enormously relative to national economies, which produced large risks to public finance (Bertay et al., 2013) and prompted government interventions. The pre-crisis period was also characterized by waves of mergers, which provided opportunities for banks to increase their size and market share (Brewer and Jagtiani, 2013) During the financial crisis, the collapse of large, globally active financial institutions threatened the stability of the financial system (Basel Committee on Banking Supervision, 2011).

This study considers the impact of size on bank earnings volatility in the UK banking system over the period 2000–2012 and compares commercial and investment banking institutions. We focus on the impact of the size because it is related directly to the TBTF issue and because the Bank of England has participated in the debate over whether major UK banks should be split up to reduce financial threats to the British Treasury.[2] (Bertay et al., 2013). The UK banking system has received extraordinary government interventions to ensure financial stability (Rose and Wieladek, 2012). According to Morrison (2012), in the case of the Royal Bank of Scotland (RBS), the State acquired 83% of the rights to RBS cash flows and 68 percent of the voting rights after the bank's recapitalization. In the Lloyds Banking Group recapitalization, the State acquired 41% of the voting and cash flow rights. In the case of HBOS the government acquired an important amount of equity stakes (Tamakoshi and Hamori, 2016). The National Audit Office (2009) provided a total of £850 billion in liquidity support and capital injections support to the UK banking sector.[3] It should be noted that the link between earnings volatility and bank failure is an important element that motivates us to investigate this relationship for UK banking institutions. Figs. 1 and 2 that illustrate the behavior of Return on Average Assets (ROAA) for UK active and bankrupted (or dissolved) respectively show that the volatility of ROAA is more intense for banks which bankrupted.[4]

Our analysis focuses on the United Kingdom because it possesses among the most open global financial centers, substantial concentration of financial institutions and highly developed infrastructure. The United Kingdom operates as a financial market hub constituting a major home and host country for both bank and nonbank financial institutions. According to the Financial System Stability Assessment Update (2011) produced by the International Monetary Fund, *"the size and the role of the UK financial system in global intermediation means that its continuing stability is a global good necessitating effecting implementation of reforms."* The pre-tax profits of UK financial institutions declined from £29.719 million in 2004 to −£20.943 million in 2008, and profits equaled £4.293 million in 2012.[5]

During the recent financial crisis, the profitability of banking institutions declined dramatically. Because a profitable banking sector contributes to the stability of the financial system and its well-functioning promotes a country's economic growth (Moshirian and Wu, 2012),the assessment of bank earnings constitutes an integral part of supervision frameworks and urges the stakeholders to identify the factors that affect the profitability (Couto, 2002). Bank earnings volatility is an important predictor of financial crises (Demirgüç-Kunt and Huizinga, 1999) and an early indicator of financial disturbances

[2] See the speech by Mervyn King, Governor of the Bank of England, on 19th June, 2013, which states that *"It is not in our national interest to have banks that are too big to fail, too big to jail or simply too big."* The speech is available at http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech670.pdf.

[3] See National Audit Office Report (2010), "Maintaining financial stability across the United Kingdom's banking system" for details.

[4] The data Derived from Bankscope Bureau van Dijk Database for the period 2000–2010. The sample of active and bankrupted financial institutions consists of 470 and 96 financial institutions respectively.

[5] Bank of England, Explanatory Notes—Annual profit and loss of UK resident monetary financial institutions, Interactive database.

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