The Separation of Banking and Commerce in the United States: an Examination of Principal Issues

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by

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1. INTRODUCTION

Banking law and regulation in the United States has customarily restricted the nonbanking activities of banks and the banking activities of nonbanking firms. These restrictions have separated banks in the financial sector from nonbanking firms in the commercial or production sector of the economy.[2]

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[2]Any dividing line between commercial banks and other commercial firms is invariably hazy, though such lines have been repeatedly drawn in banking legislation in the United States. Throughout this paper, "commercial banks" are defined to include firms offering transactions deposits and generally engaged in "the business of banking" as defined by law. This business has changed over the years in terms of types of loans, deposits, and related activities. Banks remain distinguishable, however, from other financial institutions and from the businesses of manufacturing, distribution, agriculture, communications, transportation, and the other activities that compose the commercial sector.

In most other highly industrialized countries such as Germany and Japan, the banking sector has elaborate affiliations with the commercial sector. The separation of these two activities seems to differentiate the United States from most of the rest of the world.[3]

In the United States, the prospect of liberalizing activity restrictions to permit banks to acquire larger equity holdings in commercial companies, to combine with such companies, or to control or be controlled by them has compelled a reconsideration of traditional policy.[4] The issues raised should be carefully considered. The purpose of this paper is to identify, catalogue, and elaborate these issues.

A number of key issues have already been identified and evaluated in ongoing deliberations on bank expansion into the securities and insurance businesses. Additional issues arise in connection with further expansion into the commercial sector. Although the latter are the principal focus of this paper, the former are reviewed as well.

Section 2 of this paper reviews early restrictions on bank activities in the United States and its antecedents. It contrasts developments in the United States with those in several other countries in

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[3]In recent years, technological innovation has given nonbanking firms, including computer and software firms, the capacity to offer many traditional banking products; the combination of banking and commerce appears to have become economically feasible and profitable. It is likely that it has always been so. Foreign financial companies, affiliated with commercial firms, have long competed in the United States; affiliates and subsidiaries of U.S. banking organizations abroad, restricted only by the laws of the countries in which they operate, have found commercial activities profitable for some time.

[4]The views of the federal bank regulatory agencies, developed against a background of rapidly changing technology and "globalization," have been expressed to Congress. See, for example, the testimony of Ricki Helfer, Eugene Ludwig, and Alan Greenspan before the House Committee on Banking and Financial Services, May 22, 1997. The Treasury has taken a cautious approach by proposing alternatives, one of which prohibits any further integration of banks and nonfinancial firms. See U.S. Treasury Department, "Key Provisions of the Treasury's Financial Modernization Proposal," May 21, 1997.

which banks have not been separated from commercial and industrial firms. These comparisons raise a number of issues that need to be considered.

Section 3 deals with these and other issues. The paper distinguishes financial sector issues from commercial sector issues. Other issues, arising in the public domain of central banking and supervision, transcend sectors. A discussion of socio-political and cultural issues concludes the section. Section 4 discusses the difficulties of evaluation and how the evaluation might proceed. Section 5 is a brief concluding section.

An enormous literature has developed in recent years on the separation of banking and commerce. Much of it relates directly or indirectly to the issues raised below. In addition to classifying, elaborating, and examining approaches to evaluation, much of the relevant literature is included in the pages of references that complete the paper.

Any evaluation of the alternative systems based on a few characteristics is likely to be overly simplistic. Standard cost-benefit analysis presents serious difficulties; many of the costs and benefits are not quantifiable, and some that are quantifiable are incomparable. Nevertheless, judgments informed by the best available information are possible.

2. CROSS COUNTRY COMPARISONS: AN HISTORIC PERSPECTIVE

Bank powers in developed countries have differed significantly over the last several centuries, but in many they are now converging. In such countries as England, first law and now tradition dictated a separation of banking from commercial firms. In the United States, an a heir of the English tradition, legislatures imposed restrictions early, and have formally reestablished them on a number of occasions

over the years. In Germany and Japan, on the other hand, relationships between banks and commercial firms have been intimate. This section reviews antecedents to modern differences among developed countries; it will be followed by an examination of the different paths taken in the United States, Germany, and Japan.

2.1. Antecedents

Modern banking, in the form of lending, transferring funds, and accepting deposits, developed in Mediterranean city states in the thirteenth and fourteenth centuries out of the activities of "money changers" and merchants. Bank regulation of various types developed along with it. Among the regulations from time to time were restrictions on bank activities.

Venice, for example, regulated its banks extensively. By 1270, banks were required to hold government bonds as a form of security. Over the next half-century, provision was made for public supervision. Various laws passed between 1421 and 1523 gave summary jurisdiction over questions between bankers and depositors to designated public officials. An act in 1467 limited banks to ten ducats in lending to any person upon a single obligation, presumably to promote diversification.

In addition, activities were also restricted. In 1374, the Venetian senate prohibited bankers from dealing in copper, tin, iron, lead, saffron, and honey. Nineteenth century scholars suggested that the intent was probably to keep banks from undertaking risky activities and monopolizing the specified commodities.[5] In 1450, banks were restricted in extending credit to purchase silver, presumably to limit their lending for speculative purposes.

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[5]Dunbar, 1892, pp. 311-317.

From the thirteenth century on in Europe, periodic economic and financial disruptions associated with bank failures, currency problems, and “bubbles” focussed the attention of public authorities on banking problems. When government’s found regulation unsatisfactory in the sixteenth and seventeenth centuries, they substituted public banks.[6] Public banks were established in Naples, Genoa, Milan, and Venice.[7] From the sixteenth century until the end of the eighteenth century, “the banking system on the European continent was made up of public banks. . .”[8]

The prototype was the Exchange Bank of Amsterdam, established in 1609. It had its origins in currency problems.[9]0.Smith, 1776, pp. 446-455; *The Cambridge Economic History of Europe*, 1977, pp. 336-37.[10] The bank accepted coin at its intrinsic value in return for a credit on its books in

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[6]Harsh and even capital punishment was not unusual for crimes involving banking and money. Early banking laws in Barcelona barred from banking any money changer who failed, and provided that he be disgraced by public crier and detained on a diet of bread and water until he satisfied all demands. In 1321, a provision was added that "if no . . . settlement is made . . . they shall be beheaded. . . ." In England, smelting, clipping, and counterfeiting coins was punishable by death. For information on early banking regulation in Catalonia, see Usher, 1943, in particular pp. 240, 242. With respect to England, see Bisschop, 1910, p. 40, note 1.

[7]*The Cambridge Economic History of Europe*, 1977, pp. 312-13.

[8]deRoover, 1974, p. 229.

[9]A description of the problem encountered by Amsterdam can be found in Adam Smith’s *Wealth of Nations* [Smith, 1776

(1937)]. He observed that trade brought a large quantity of clipped and worn foreign coin to the city. Freshly minted coins with the standard amount of silver disappeared from circulation quickly. Merchants could not always find a sufficient quantity of good coin to pay their bills, and the value of their debts became uncertain. In these circumstances, private bankers could earn a profit by segregating the best coins and selling them to merchants at a premium. Increases in the market value of the "good" coins placed pressure on the mint to raise the price of freshly minted coin, and made it impossible to sustain the official rate. With the failure of regulation to solve the problem, the city established the Bank of Amsterdam and effectively eliminated private banking. The operations of the bank restored the

"bank money," that is, in accordance with the official standard of value established by the city. It decreed that all merchant bills in Amsterdam above a minimum value (600 guilders) had to be paid in "bank money." As a result, merchants were obliged to keep deposits with the bank. Depositors could transfer any amount in their accounts to a creditor, or pay in specie through the bank, which provided a clearing facility. The city made itself liable for deposits. The city obtained substantial revenues through a variety of charges and fees.

The Bank of Amsterdam, and other banks modeled after it, were "transfer banks," substituting "bank money" for coin. They were not supposed to make loans. According to Adam Smith, the Bank of Amsterdam "professes to lend out no part of what is deposited with it, but, for every guilder for which it gives credit . . ., to keep in its repositories . . . money or bullion . . . for which it is at all times liable to be called upon . . . ."[11] In more modern terminology, the intent was to make it hold "100 percent money,"[12] an extreme form of what is currently termed a "narrow bank." As such, it should have been failure-proof.

Intent and reputation, notwithstanding, almost from its origin, the Bank of Amsterdam covertly extended credit to government and government-affiliated institutions.[13] Ultimately, in the last decade of

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standard of value and reduced the uncertainty as to the value of debt.

[11]Smith, 1776, pp. 453.

[12]Fisher, 1935, pp. 33 ff.

[13]These included the Municipal Treasury, the Provincial States of Holland, the Masters of the Mint, and the East India Company.

the eighteenth century, with bad loans and impaired liquidity as a result of the disclosure, it effectively failed.[14]

2.2 The English Legacy[15]

Banks in the United States were patterned after the Bank of England, which was organized on different principles than the public banks on the continent, but whose charter restricted activities also. Prior to the establishment of the bank in 1694, private banking developed principally through an extension of the goldsmiths' businesses.[16] The advantages provided by the public banks on the Continent had been well-known in England, but the example was not adopted.

The Bank of England was chartered to extend credit to the government at a relatively low rate of interest. It was granted a corporate charter by Parliament. The organizers of the bank agreed to lend the entire capital of the bank (£1,200,000) to the government at a rate of 8 percent, well below the rate it would otherwise have had to pay. They received authority to conduct a banking business, which enabled them to issue promissory notes payable on demand.

A corporate charter in 1694, prior to general incorporation laws, constituted a delegation of public functions to private individuals. It was not unusual in England, and elsewhere, for governments to make such delegations to provide transportation, water, and education; to collect taxes; and to fund mercenary armies.[17] In English law, the charter was a grant of a franchise by a sovereign authority, that

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[14]See deRoover, 1974, pp. 227-28. The bank was ultimately closed in 1816.

[15]This section and the section 2.3 that follows draws on Shull, 1994.

[16]Holdsworth, 1923, pp. 183-85.

[17]Hurst, 1973, pp.152 ff.

is, a "privilege" to run a specific enterprise or to trade in a particular area for a specified period of time. Each was a product of negotiation which was perceived as resulting in a contractual relationship.[18] The grant meant that the business could maintain its debts in the name of the corporation, which could sue and be sued on its own behalf, and continue to exist even though ownership and management changed. Judges inferred limited liability for stockholders from the fact that the corporation alone was liable for its debts.

The grant, by its nature, implied “monopoly privileges.” Governments typically required safeguards for itself and other commercial interests. Among other things, the activity of the corporation was defined and, thereby, limited in scope. The legal scholar Adolph A. Berle suggested that "in theory this was probably designed to prevent corporations from dominating the business life of the time . . ."[19] But definition also permitted the stockholders to know how their investment was used. Capital requirements were established to protect creditors against excessive leverage. Government took on a monitoring function.

Monopoly grants provoked complaints. When the Bank of England was established, merchants complained about the possibility of unfair competition. A provision was added to the act establishing the bank, restricting its activities.

> And to the intent that their Majesties subjects may not be oppressed by the said corporation by their monopolizing or engrossing any sort of goods, wares or merchandise be it further declared

[18]The development of the modern corporate charter is traced in Berle and Means, 1940, pp. 128 ff.

[19]Berle and Means, 1940, p. 131.

> . . . that the said corporation . . . shall not at any time . . . deal or trade . . . in the buying or selling of any goods, wares or merchandise whatsoever . . . .[20]

For more than a century, the Bank of England continued to help finance the government and, in return, the bank's monopoly of bank notes was repeatedly confirmed and fortified.

By the second half of the eighteenth century, new banks were nevertheless being organized on the periphery of the Bank of England's monopoly. At the beginning of the nineteenth century, joint stock banks offering deposits had found a way around the bank's privileges. It was not, however, until the second and third decades of the nineteenth century that Parliament began to proscribe the Bank of England's monopoly, and by the middle of the century it had evolved from a commercial bank to a central bank.[21]

Banking in the United Kingdom today is distinctive in that, the Bank of England's history notwithstanding, there are few explicit legal restrictions on the types of business a bank can undertake. As a result, the U.K. is sometimes listed as providing very wide banking powers, among which is a bank's ability to hold the equities of commercial firms and a commercial firm's ability to hold bank equities.[22] Nevertheless, it has only been since the "Big Bang" in 1987 that commercial banks moved aggressively into securities trading and insurance through subsidiaries.[23] Tradition and moral suasion, exercised by the Bank of England, have effectively constrained the mixture of banking and commerce.

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[20] 5 & 6 William & Mary c. 26.

[21] See Andreades, 1966, pp. 248-55 and 258-62.

[22] Barth et al., March 1997, tables 4 and 5; Institute of International Bankers, September 1995, p. 16.

[23] Llewellyn, 1995, pp. 2-3.

In principle, banks may own commercial firms and commercial firms may own banks, provided that they are considered to be "fit and proper" owners by the bank supervisor. In practice, such ownership arrangements are not widespread. Banks have not chosen, except through relatively small venture capital subsidiaries, to own commercial firms. The Bank of England has indicated that it would not favor controlling investments by industrial firms in major banks.[24] Another way of looking at conglomeration in the U.K. is to say that British banks have not taken advantage of the scope of their permissible powers.[25]

2.3 The United States [26]

Early banks in the United States were patterned after the Bank of England. Each charter was subject to bargaining between applicants and legislatures. Everything was negotiable, including the length of the charter, capitalization, branching restrictions, and the price to be paid by the applicant.[27] As in the case of the Bank of England, bank activities were restricted.

Charters of early U.S. banks were not always specific in their definition of banking, but they typically prohibited banks from dealing in merchandise.[28] In 1785, for example, the state of Pennsylvania repealed the charter it had granted to the Bank of North America, in part on the grounds

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[24]Institute of International Bankers, 1995, p. 16; GAO, 1994, p. 11.

[25]Llewellyn, 1995, pp. 4,5; Goodman et al., 1984, pp. 95 ff.

[26]In addition to drawing on Shull, 1994, more extensive references can be found in Shull and White, 1997.

[27]Dewey, 1910; Ng, 1988, pp 886-87.

[28]Dewey, 1910, p. 43; Hammond, 1957, pp. 129-31, 593.

that there were insufficient limits on the bank's powers. The bank was rechartered in 1787, with limits on its activities, including a restriction on dealing in merchandise. In New York, none of the bank charters issued before 1825 contained a definition of what banks could do. The legislature relied on restrictive clauses inserted in each charter. Each charter declared that trading or dealing in "stocks" (securities), goods, wares, and merchandise was not within the scope of banking.

Banking powers in the United States were defined for the first time by New York in 1825. In granting two bank charters, the state established a definition, which in modified form was widely adopted in subsequent legislation. The definition indicated that banks would:

> possess all incidental and necessary powers to carry on the business of banking S by discounting bills, notes and other evidences of debt; by receiving deposits; by buying gold and silver, bullion and foreign coins; by buying and selling bills of exchange, and by issuing bills, notes and other evidences of debt; but the said Company shall have and possess no other powers whatever, except such as are expressly granted by this act . . . [29]

Corporate charters granted to banks in the United States continued to be legislative grants until passage by states of "free banking" laws beginning in the late 1830s. Among other things, these laws provided for bank chartering through an administrative process that set no limits on the numbers of charters that could be issued, and made bank charters relatively easy to obtain. Nevertheless, even as states began passing general incorporation laws that produced the modern corporate charter "readily available and a right to conduct any lawful business," banking remained restricted by special charters

[29]*The Legislative History of Banking in the State of New York*, 1855, pp. 19-20. This specification was incorporated into general law in 1827. From 1829 to 1838, when New York's "General Banking Act" was passed, the legislature, "notwithstanding the express prohibition [in state law against dealing in merchandise, etc.] . . . from abundant caution, inserted in each of these charters, an express prohibition against these banks, dealing or trading in . . . goods, wares, merchandise, commodities . . . ." *The Legislative History of Banking in the State of New York*, 1855, p. 53.

that granted a right to a defined enterprise.[30] The understanding remained, throughout this period, that banking was an exercise of “public powers,” and that “public powers are never granted without some public object in view: S especially is this true, in respect to banking corporations, whose operations affect the currency, and thus the whole community.’[31]0.“The Early Days of the Bank of New York;” undated pamphlet, pp. 13-19; Dewey, 1910, pp. 209 ff.[32]0.Hammond, 1957, pp. 467 ff. The bank's failure was followed by a grand jury indictment of its President (Nicolas Biddle) for conspiracy to defraud the shareholders; the indictment was quashed. He was, it was suggested in a review of the issues 50 years later, not guilty of anything but bad banking. See H. White, “The Second Bank of the United States, Part II: the Bank War,” *Sound Currency*, September 15, 1897, p. 12. [1]

In New York State, the issue of banking powers was dealt with by adopting the definition of banking along the lines noted above. An important court decision held that "independently of the general Bank Act [of 1838], these banks have no corporate existence, and they are thus created with restricted

[30]See Berle and Means, 1940, pp. 135-36.

[31]*Bank of Utica v. Smedes*, 3 Cowen 684, as reproduced in *Legislative History of Banking in the State of New York*, 1855, p. 112. Banks, like the Bank of North America, were expected to lend to the governments that chartered them, as well as to merchants. The Bank of New York took pride in the accommodation it could provide the state and the federal government. In Pennsylvania, each bank chartered was required to lend to the state as a condition of the charter.

The Bank of the United States, established by Congress in 1791, similarly provided the Federal government with financial assistance. States, needing to build roads, canals, and later railroads, chartered banks to finance internal improvements. Commercial groups such as farmers, cotton growers, lumberman, and mechanics were able to persuade legislatures that it was in the public interest to charter banks to serve their special needs. A compilation of the various purposes for which bank charters were issued can be found in Dewey, 1910, pp. 48-51. A notable example of granting more expansive powers involved the rechartering of the Second Bank of the United States by Pennsylvania after its federal charter expired in 1836. The bank thereafter invested heavily in securities, attempted to support the market for cotton, and failed in 1841.

and limited powers, for a special purpose.'"[33] Nevertheless, in 1857 the New York Court of Appeals acknowledged that the act did not list all authorized powers, including, but not necessarily limited to, those implicit powers needed to exercise powers that were listed. In particular, it decided that banks had the right to borrow money by issuing bonds, though this power was not a specified in the act.[34] However, bank powers, whether explicit or implicit, did not include the power to engage in mercantile enterprises. As late as 1854, banking legislation introduced in the New York state legislature to establish standards for the formation of banking corporations, included the provision that the corporation "shall not, directly or indirectly, deal or trade in buying or selling any goods, wares, merchandise or commodities . . . ." The provision apparently existed in all bank charters.[35]

When the federal government returned to bank chartering with the passage of the National Banking Act of 1863-64, the bank power clause of New York's Free Banking Act served as the model. Court interpretation restricted expansion.[36] National banks were permitted to make loans on "personal security," which was taken to imply that they could not make mortgage loans. In litigation it was determined that they could not in general invest in real estate; that they could accept corporate

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[33]*The Legislative History of Banking in the State of New York*, 1855, p. 111; for a more recent analysis, see Symons, 1983, pp. 691 ff.

[34]*Curtis v. Leavitt*, 15 N.Y. 2 (1857). For an analysis of this and related court decisions in New York with respect to powers clause in the Free Banking Act of 1838, see Symons, 1983, pp. 694-98.

[35] For example, "An Act to Authorize the Forming of Corporations for Banking Purposes," No. 128, Assembly, State of New York, March 28, 1854.

[36] In addition to the powers specified as "the business of banking," national banks were also authorized "to exercise . . . all such incidental powers as shall be necessary to carry on the business . . . ." For reviews of court decisions see *Harvard Law Review*, 1920, p. 718-721.

stock as collateral and as payment for debt, but could not deal in or purchase stock as an investment; that they could not under any circumstances become a partner in a business in which they could incur unlimited liability; and that they could not engage in the operation of a business, even if it had been acquired in satisfaction of a debt. The national banking system, thus, continued its distinctive legal treatment of commercial banks in restricting their activities.

By the late nineteenth century, large national banks in New York and Chicago had begun to undertake investment banking activities in their bond departments. The Comptroller, influenced by adverse court decisions, interpreted the National Banking Act to preclude some of the investment banking activity undertaken directly. In the early years of the twentieth century, the OCC began to inform national banks that they were not permitted to hold corporate stock.[37] Banks responded by organizing securities affiliates.[38] Principally owned pro rata by bank stockholders and controlled by bank management, the affiliates were state-chartered firms with general powers that permitted almost any kind of activity.[39] Formal and informal affiliations of investment and commercial banks with

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[37] See the Comptroller's *Annual Report* for 1915, pp. 35-36 for references to a letter sent by the Comptroller to a national bank around 1903 drawing attention to a Court decision stating that "(t)he power to purchase or deal in stock of another corporation is not expressly conferred upon national banks, nor is it an act which may be exercised as incidental to the powers expressly conferred."

[38] George Baker, Chairman of the Board, of First National Bank of New York testified in 1913 that his bank's affiliate, First Security Company, was organized "(f)or doing business that was not specially authorized by the banking act. We held some securities that in the early days were considered perfectly proper, but under some later decisions of the courts the holding of bank stock or other stock was prohibited; at any rate the comptroller prohibited it" ("Pujo Committee Hearings," 1913, p. 1424; see also p. 1432).

[39] Realty, insurance and mortgage company affiliates were also acquired and frequently had their main offices in the same building as the bank.

securities affiliates constituted the beginnings of a type of “universal banking” in the United States around the turn of the century.[40]

State banks, originally suppressed by a prohibitive tax on state bank notes, were revived in the 1870s and 1880s by deposit banking. Along with trust companies and unincorporated banks, they confronted national banks as relatively unregulated competitors that could offer a wider range of services.

The Federal Reserve Act of 1913 provided for a moderate expansion of national banking powers by permitting real estate loans, time and savings deposits, trust services, and foreign branches. The expansion did not materially disturb the security affiliates of national banks or state banking powers. In 1927, the McFadden Act gave national banks explicit authority to buy and sell marketable debt obligations. The Comptroller ruled that national banks could underwrite all debt securities and that their affiliates could underwrite both debt and equities.

This arrangement was transformed by the Banking Act of 1933. The Glass-Steagall provisions of the act revoked the powers that had been granted by the McFadden Act and mandated a separation between commercial banking and investment banking.[41] Passed in the wake of the stock market crash

[40]The Pujo Committee Report of 1913 is a compendium of issues still raised in debate about the costs and benefits of “universal banking.” For example, the Report argued, among other things, that bank funds were likely to be used to finance speculative operations (p.155), that the mistakes of affiliates were likely to impact the bank (p. 155), and the relationships between banks and the industrial and railway companies they financed would compromise the interests of creditworthy borrowers (pp. 159-60).

[41] The relevant sections are 16, 20, 21 and 32. Sec. 16 limits bank dealing and underwriting to specified types of securities, i.e., obligations of the United States and general obligations of states and political subdivisions. Sec. 20 prohibits banks from having affiliates principally engaged in dealing in securities. Federal Reserve interpretation of Section 20 has permitted holding company affiliates to

of 1929, the failures of thousands of banks during those same years, and the slide of the U.S. economy into the worst depression of its history, the act was motivated by Congress' perceptions that some commercial banks' securities activities had helped fuel the stock market speculation of the late 1920s prior to the crash; that some banks had not honored their fiduciary responsibilities to their customers because of improper securities activities; and that the failures of some banks in the early 1930s was related to their securities activities.[42] Senator Carter Glass, a principal author of the act, believed, moreover, that a proper and stable banking system required that banks be restricted to short-term lending.

Following passage of the Glass-Steagall Act, many affiliates surrendered their charters and liquidated their assets. In some cases, affiliates separated from parent banks and continued as independent organizations, e.g. First Boston Corporation separated from First National Bank of Boston. Private investment banks had to choose between accepting deposits and dealing in securities; J.P. Morgan split into Morgan Guaranty and Morgan Stanley, along the lines required by the act.

While some commercial banks continued to deal in securities to the limited extent permitted by the 1933 act, for roughly 50 years thereafter there was little involvement in the business. Beginning in the early 1980s, however, banks began again to expand their securities operations and, over the past decade, have done so through the bank holding company mechanism.

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underwrite otherwise impermissible securities. Sec. 21 prohibits firms dealing in securities from accepting deposits. Sec. 32 prohibits interlocks of directors and officers of securities firms and banks. The overseas investment banking operations of U.S. banks were not affected by the act. Nor did it apply to state-chartered nonmembers.

[42]But see Benston (1990) for a critical review and rejection of much of the evidence regarding these claims.

Bank holding companies have traditionally been an alternative way for commercial banks to expand into new activities. Prior to 1933, they were not restricted by federal law. The Banking Act of 1933 imposed limited restrictions involving registration with the Federal Reserve.[43] Companies that owned banks could and did find ways to avoid them. By 1954, only 18 of the 114 bank holding companies identified by the Federal Reserve had registered.[44]

The essentially unrestricted growth of bank holding companies was terminated with the Bank Holding Company Act of 1956 (BHCA). The act was motivated by Congress' desire both to prevent the spread of interstate operations by holding companies and the expansion of bank holding companies into "nonbanking" activities through affiliates. Bank holding companies were defined as organizations that controlled two or more banks. The act prohibited bank holding company control of almost all nonbanking firms. Under its provisions, activities were to be "of a financial, fiduciary, or insurance nature" and "so closely related to *the business of banking* or managing or controlling banks as to be a proper incident thereto (italics added)." The Federal Reserve Board narrowly interpreted the term "the business of banking" to mean a relationship between the customers of specific banks and their nonbanking affiliates.[45]

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[43]Corporations owning more than 50 percent of the stock of one or more Federal Reserve member bank were required to apply to the Federal Reserve to secure permits to vote their stock.

[44]*Bank Holding Company Act, 1955*, p. 8.

[45]Transamerica had become symbolic of the holding company as a device for combining banking and other kinds of businesses. In 1954, in addition to controlling banks in five western states, its nonbanking subsidiaries included insurance companies (Occidental Life and others), real estate and oil development companies, a fish packing company, and a metal fabricating company (*Control of Bank Holding Companies*, 1955, pp. 52, 62-63). Passage of the Bank Holding Company Act of 1956 was a victory for the Federal Reserve that had, to that point, been unsuccessful in restricting the growth of

A number of large commercial and industrial firms, such as W.R. Grace, R.H. Macy, and Corn Products Refining, continued to own a small bank to accommodate employees.[46] Until the mid-1960s, however, the one-bank company remained for the most part a small firm controlling a small bank in a unit banking state.[47]

Commercial banks began to broaden their activities in the early 1960s, with the help of interpretations by the Comptroller of the Currency of the "incidental powers" clause of the National Banking Act. The new or expanded activities permitted by the Comptroller included data processing services, insurance agency and travel agency services, mutual funds, and revenue bonds underwriting. Many of the Comptroller's decisions were challenged in litigation. In the late 1960s, however, banks found that they could affiliate with almost any kind of nonbanking firm without legal challenge by reorganizing into one-bank companies. By 1969, the largest banks had done so.

The realization that the 1956 act had left a large loophole with respect to nonbank activities that was being exploited, and growing political concern in the 1960s about the growth of conglomerate enterprises through mergers led to the 1970 amendments to the BHCA.

Sec. 4(c)(8) of the 1970 amendments liberalized activity restrictions. In the phrase "so closely related to *the business of banking* or managing or controlling banks as to be a proper incident thereto, the term "*the business of*" was eliminated to make clear that the new nonbanking activity should be

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Transamerica. Transamerica decided to withdraw from banking. It spun off all but one of its banks to the newly established Firstamerica Corporation in order to retain control of its nonbanking subsidiaries.

[46] *Control of Bank Holding Companies*, 1955, p. 121.

[47] *Federal Reserve Bulletin*, 1972, pp. 999-1000.

related to banking in general, and not to the business of specific institutions. The new legislation authorized the Federal Reserve Board to permit activities it had determined are "so closely related to banking or managing or controlling banks as to be a proper incident thereto." The "proper incident" phrase established a "net public benefits" test that required the Fed to weight the benefits of the new activity on increased competition, efficiency, and convenience against any costs of increased concentration, less competition, and diminished bank soundness. The Federal Reserve's determinations under the act since its existence have been widely reported.

Over the past two decades, additional legal and market changes have had a substantial impact on activity expansion by banks. S&Ls, like commercial banks, have been treated distinctively by Congress since the early 1930s. Reorganized under the Home Owners Loan Act in 1933 and provided with deposit insurance by the National Housing Act of 1934, the old mutual was fortified to promote housing finance. The redesigned S&Ls were not subject to Regulation Q, the Glass-Steagall Act, the McFadden Act and, subsequently, the Bank Holding Company Act.

The first S&L holding company (Great Western Financial Corporation) was organized in 1955 by Lehman Brothers, a securities firm. Legislation in 1959 limited such holding companies to no more than one insured S&L. The Savings and Loan Holding Company Act of 1968 permitted unitary S&L holding companies meeting a "thriftness" test (a minimum percentage of assets in mortgages and other specified securities) to engage through other subsidiaries in any activity. Thus, through a holding company, Sears, Roebuck & Co. could own a retail enterprise as well as an insurance company, a securities firm, a real estate development company, and an S&L. Such activities were effectively

combined with "banking" when S&Ls became commercial bank-like institutions in the early 1980s with federal authority to provide checkable deposits and make commercial loans.

A direct incursion into banking by nonbanking firms was made possible by the creation of "nonbank banks." A redefinition of the term "bank" in the Holding Company Act Amendments of 1970 had opened another loophole. Banks had been redefined in the 1970 legislation as institutions that provided demand deposits and made commercial loans.[48] Beginning in 1980, large conglomerates, securities firms, and insurance companies exploited the loophole by acquiring banks that refrained either from commercial lending or taking demand deposits. By the mid-1980s, General Electric, J.C. Penney, Gulf +Western, ITT, Prudential Bache, Merrill Lynch, and others owned such banks.[49] At the same time, investment bankers expanded their control of commercial firms whose securities they were underwriting.[50]

Congress closed the “nonbank bank” loophole with passage of the Competitive Equality Banking Act of 1987 by again changing the definition of "bank" in the Holding Company Act; all institutions with deposit insurance were included. Congress grandfathered the existing ones and placed a ceiling on their future growth.

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[48]In 1933, holding company restrictions were imposed only on firms owning a Federal Reserve member bank. The Bank Holding Company Act of 1956 redefined "bank" to include "any national banking association or any state bank, savings bank or trust company." In 1966, to avoid covering savings banks, industrial banks, and non-deposit trust companies, Congress changed the definition to cover only institutions that accepted demand deposits. In 1970, to avoid including trust companies that accepted demand deposits but did not make commercial loans, notably Boston Safe Deposit & Trust, "bank" was again redefined to include institutions offering both commercial loans and demand deposits.

[49]U.S. Treasury Department, 1991, pp. XVIII-21 ff.

[50]See *Business Week*, 1988.

Glass-Steagall Act restrictions eased in the 1980s. The FDIC, after determining that the act did not apply to affiliates of nonmember insured banks, permitted them to offer securities services. By the early 1990s, roughly half the states had authorized banks to deal in securities beyond the limits established by federal law and regulation.[51] Federal Reserve interpretation of the Glass-Steagall Act and Section 4(c)(8) of the Bank Holding Company Act in the late 1980s provided holding companies with authority, albeit limited, to deal in and underwrite a wide variety of securities. In recent years, it has repeatedly expanded the scope of operations for Section 20 subsidiaries.

Throughout this recent period, the definition of "control" has been a regulatory focal point. In general, control of a firm in an impermissible business is prohibited.[52] But limited equity investments, e.g., in the form of equity kickers, are generally permitted. Exceptions to general prohibitions and limits are made for investments in publicly-favored areas, e.g., through small business investment companies for low-cost housing and community redevelopment.

This review of activity restrictions in banking suggests that the development of the bank holding company as the principal vehicle for activity expansion was accidental. It resulted from unforseen exploitation of the one-bank holding company loophole in the late 1960s and a Congressional decision to plug the loophole by expanding bank holding company powers in a limited manner. Had an "incidental powers" loophole existed in the National Banking Act, Congress would have been

[51]U.S. Treasury Department, 1991, pp. XVIII-16.

[52]Whether or not control exists is determined through diverse regulatory standards for different classes of bank and banking organizations. In general, under the Bank Holding Company Act, there is a rebuttable presumption that ownership of a 5 percent to 25 percent share constitutes control and a conclusive presumption for over 25 percent. In 1986, the Federal Reserve permitted Sumitomo, a bank holding company, to invest in 24.9 percent of the partner's capital stock in Goldman Sachs.

compelled to deal with the issue earlier. If it responded as it did in 1970, it would have closed the loophole while permitting expanded powers either in national banks themselves or in their operating subsidiaries. A different avenue for activity expansion would have been established.

In 1994, the OCC proposed, and in 1996 it adopted, a revision of "part 5" (12 CFR part 5) permitting national banks to engage in a variety of activities, permissible to national banks, through operating subsidiaries. Some of the activities not currently permitted to the parent bank could, on application by well-managed and capitalized banks, be permitted in such subsidiaries. This revision has generated widespread comment and debate among bank regulators as to the appropriate organizational structure for nontraditional activities.[53]

2.4 Other Countries

Internationally, the spectrum of banking powers is broad. In theory, it is possible to group countries from most restricted to least. In practice, groupings based on written law and regulation are unlikely to capture informal behavior manifest in subtle rules, preferred corporate organizational form, moral suasion, and tradition. The importance of informal practice has already been discussed in the case of the United Kingdom.

This section reviews the unique institutional development of Germany and Japan that have shaped actual practice, along with explicit law and regulation. Formal classification places Germany with those countries affording banks moderately "wide" powers; Japan and the United States are in the

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[53]For a recent review of advantages and disadvantages of alternative organizational structures, see Shull and White, 1997.

"restricted" group.[54] The laws and regulations that dictate these classifications are less than meet the eye. The section concludes with a brief description of the changes introduced by the European Union.

2.4.1. *Germany*

Universal banks are typically defined as banks that provide short-term banking credit as well as intermediate and long-term capital through underwriting and investing in equities; a characteristic of a universal banking system is the close and long-term relationships, through boards of directors and in other ways, between banks and the commercial/industrial companies to whom they provide credit and in which they have an ownership interest. The German banking system has been the prototype. Similar banking arrangements can be found on the Continent in Spain, Switzerland, France, and Norway.

Universal banks in Germany emerged in the late nineteenth century as part of a government effort to industrialize quickly.[55] They grew out of the operations of private bankers who accepted deposits and underwrote securities.[56] These private bankers underwrote sovereign issues and helped

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[54]See, for example, Barth et al., 1997, table 5, and Institute of International Bankers, September 1995, p. 12.

[55]Tilly, 1994, p. 300. Industrialization required substantial amounts of new capital. It is more or less generally accepted that both the French Credit Mobilier and German political history influenced the way this need was met. The Credit Mobilier was established in France in 1852, receiving the right to issue interest-bearing notes to the public. While much of its investment was in public works (Kindleberger, 1993, pp. 110-111), it served as a model for investment banking for much of Europe. In the latter part of the nineteenth century, while integration of the several German states was in process, individual states prohibited private bankers and mixed banks from issuing promissory notes out of concerns about inflation and the maintenance of stable exchange rates. Government banks of issue, then, dominated short-term trade credit and the payments system. Private bankers and universal banks focussed on longer term industrial credit and the securities business (Tilly, 1994, p. 303). The establishment of the German Reich, and the founding of the Reichsbank with extensive branching and giro services reinforced this division (Tilly, 1994, p. 304).

[56]Baums and Gruson, 1993, p. 102.

finance the building of the German railroads in the 1830s and 1840s. To monitor and insure their investments, they controlled key executive positions in the railroads, either by filling these positions themselves or appointing representatives. While they didn't have authority to issue bank notes, their "acceptance credit" nevertheless circulated as a means of payment.[57]

In the developing economy of the second half of the nineteenth century, capital needs frequently exceeded the resources of individual bankers. Syndicates were organized to float securities. Joint stock banks were organized as a type of permanent syndicate.

For the most part, private bankers and the banks that followed dealt with large scale industry and wealthy individuals. After advancing large amounts of funds for working and fixed capital, the banks converted these loans to marketable debt or equity. The banks also provided "current accounts" that established deposits with overdrafts on which interest was respectively paid and charged; these accounts were usually collateralized by mortgages, real property, bonds, or shares.[58]

The deposit and lending arrangements of these Kreditbanken naturally led to intimate relationships with the industries they were financing. A simple way of reducing the risks of what was, in essence, a risky lending operation was to require the borrower to conduct business through one bank (or the lead bank if securities were floated by a syndicate) and bank officials to be appointed to the supervisory board of borrowing firms. These measures gave the banks important information on the borrowing firm's condition and a voice in policy-making. Germany had neither antitrust laws nor

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[57]Tilly, 1994, p. 301.

[58]Neuberger and Stokes, 1974, p. 713 ff.

restrictions on interlocking directorates.[59] Control of major commercial and industrial firms through direct ownership of stock, proxy rights, and interlocking directors became characteristic.[60] Close, long-term relationships were nurtured.[61]

In 1913, Germany's three largest corporations were universal banks.[62] By dealing only with large-scale ventures and wealthy individuals, the Kreditbanken left a vacuum into which other financial institutions entered. Savings banks (municipal institutions) and credit cooperatives developed to meet the needs of small and new businesses and farmers. In the latter part of the nineteenth century, the "Great Banks" targeted small savings accounts as a new source of capital and began opening branches to collect these funds. The savings banks responded through regional associations and demanded the right to accept demand deposits, to maintain "current accounts," and to deal in securities. In the 1920s, the savings banks also became universal banks.[63] It has been suggested that one factor contributing to the German banking crisis of the early 1930s was "hypercompetition."[64]

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[59]Newberger and Stokes, 1974, p. 713.

[60]Krummel, 1980, pp. 46-50; Roth, 1987.

[61]Tilly, 1994, 302.

[62] See Riesser, 1911, pp. 641 ff.; Neuberger and Stokes, 1974, pp. 711-13. The three were Deutsche Bank (Berlin), Dresdner Bank, and Disconto-Gesellschaft Bank (Berlin). Other large *Kreditbanken* included Bank fur Handel und Industrie (Darmstad), A. Schaaffhausen'scher Bankverein (Cologne), Berliner Handelsgesellschaft, Commerz- und Disconto-Bank (Hamburg), and Nationalbank fur Deutschland (Berlin).

[63]Tilly, 1994, p. 306.

[64]Tilly, 1994, p. 306-07.

The German banking crisis of the 1930s resulted in further banking concentration into a "Big Three" (Deutsche Bank, Dresdner Bank, and Commerzbnk). In regulating commercial banking, the government established barriers to entry (a "needs test") and invested in bank shares (the shares were later resold on favorable terms to the banks).[65]

After World War II, the Allies responded to the close ties of German banks to heavy industry and their cooperation with the Nazi government by forcing a "deconcentration." However, reconcentration into the Big Three followed. In addition to the large commercial banks and savings banks, credit cooperatives adopted universal banking practices in the 1970s.[66] The Big Three's share of total credit provided by commercial banks, savings banks, and credit cooperatives fell considerably from 1950 to the late 1980s. At the beginning of 1994, they held about 11 percent of the total assets of all German credit institutions.[67] The Big Three's share of bank-held equity in nonbank enterprises was, however, about 40 percent in the mid-1970s; it held about 56 percent of all outside directorships held by German banks.[68] In 1987, the West German Public Monopolies Commission reported that the Big Three held 76 positions on boards of the top 100 German firms.[69]

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[65]Tilly, 1994, p. 307.

[66]Tilly, 1994, pp. 308-09.

[67]GAO, 1994, p. 11.

[68]Tilly, 1994, p. 309.

[69]Roth, 1987.

Today, any bank licensed in Germany may conduct a universal banking business. Other categories of banks that may do so include savings banks (owned mostly by municipal governments), mortgage banks, credit cooperatives and securities firms.

2.4.2. *Japan*

Japanese leaders were persuaded by Western intrusion in China in the mid-nineteenth century that Japan needed a modern army and navy. The Meiji regime, which replaced the Tokugawa shogunate in 1868, began the process of adopting European manufacturing methods to build a military force that could successfully resist foreign expansion.

The government nationalized key industries.[70] A Ministry of Industry was established in 1870 to encourage, through subsidies and credit, the development of private enterprises with military applications. By the late 1870s, a banking system had been established. State policy and the interests of private bankers combined in the development of industries essential to the military and colonial expansion.[71] In 1882, the Bank of Japan, a central bank with a monopoly of note issue, came into existence. Other types of financial institutions including savings institutions, insurance companies, and a postal savings system followed.

In effect, feudalism had been replaced by something like mercantilism.[72] Unlike developments in England and elsewhere, the industrial revolution of the Meiji restoration did not involve a rising business

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[70]Lockwood, 1954, pp. 16 ff. A history of Japan's financial development can be found in Goldsmith, 1983.

[71]Lockwood, 1954, p. 22.

[72]Lockwood, 1954, p. 504.

class, nor did it represent a democratic revolt that transferred political power to representatives of businessmen, farmers, and workers. The Meiji government had created the new system by issuing bonds to government officials and to samurai, thus creating a class that could invest in corporate stock. The new industrialists, landlords, and financiers who shared power with the military had been recruited from the nobility.[73]

During the 1880s, Mitsui, Mitsubishi, Sumitomo, Yasuda, and Dai-Ichi, through holding companies, accumulated a range of important industrial firms around their private banking enterprises.[74] Practically all of the component firms of each zaibatsu adopted corporate form. The corporations were established as, or became subsidiaries of, a holding company, with the top company laying down general policies for the entire group. Internally, the several corporations were formally related through interlocking directorates and through loans and equity holdings of the "main bank."[75] The degree of centralization varied among the several holding companies and apparently changed over time. The share in the top holding company of each zaibatsu was predominantly held by members of one family or their close associates. Sometimes it was vested in a single individual.[76]

In the Tokugawa regime that preceded the Meiji regime, business had been characterized by price fixing and cooperatively set production limits. The persistence of family patterns was evident in the operations of large combinations of industrial firms and banking through zaibatsus. Zaibatsus appeared

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[73]Lockwood, 1954, p. 10.

[74]Goldsmith, 1983, pp. 62-63; Lockwood, 1954, pp. 220-235; 507-508.

[75]Lockwood, 1954, p. 12.

[76]Goldsmith, 1983, pp. 61-62.

to follow the traditions of feudal families and guild monopoly. There is some disagreement on the extent of competition and cooperation among them. One scholar has described their behavior as "a rather indeterminate blend of sharp jealousy and mutual solidarity, of rugged individualism and collusive action; they frequently cooperated to suppress competition."[77] During the first decades of the twentieth century, the zaibatsus grew substantially through vertical integration and horizontal merger.

As in the case of the German cartels after World War II, the U.S. occupation authorities perceived the zaibatsus to be instruments of the Japanese militaristic policies. A special commission was organized to dissolve them. The old zaibatsu banks, however, were not dismantled. In addition to prohibiting corporate officials from serving in more than one corporation at a time, Glass-Steagall restrictions were imposed under the Securities Transaction Act of 1948. The act prohibited Japanese banks from engaging in the securities business, reserving underwriting of corporate bonds and stocks to securities companies. Banks, nevertheless, developed into "advisors" for their associated companies, providing advice on market issues. To their main bank, commercial companies delegated authority to negotiate deals with the securities firms that underwrote their issues.[78]

As early as 1949, the banks and the companies that clustered around them were purchasing small volumes of each other's stock. Banks became both creditors and shareholders in associated companies. These new conglomerate groupings were termed keiretsus. By 1980, six groups were associated with 190 major "core companies." Liberalization, including expansion in the scope of

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[77] The quote is from Lockwood, 1954, p. 12; see also, pp. 228-30.

[78] Goodman et al, 1984, p. 102.

banking activities, began in the late 1970s.[79] The Financial System Reform Law of 1992 permitted Japanese banks to conduct securities business through subsidiaries in which they had a 50 percent or greater share.[80] The close ties between banks, commercial firms, and the government have not been fully revealed in law and regulation.[81]

The continued close relationship between the Japanese banks and the government has been manifest in the serious difficulties of recent years. In 1990, the large Japanese city banks had the highest ratio of market capitalization-to-assets of all the major international banks.[82] However, they soon thereafter experienced serious problems resulting from large numbers of nonperforming loans, particularly real estate loans. In 1996, the loan problem was estimated to be in the neighborhood of $326 billion.[83] The Ministry of Finance announced in 1995 that Japan's large banks would not be permitted to fail.[84]

2.4.3. *European Union and Canada*

The Second Banking directive contains a broad list of securities and commercial banking activities that EU "credit institutions" (firms engaged in deposit-taking and lending) may conduct.

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[79]Viner, 1988, pp. 72-73. Laws and regulations restricting the scope of bank business began to be liberalized in the late 1970s. On the causes of the liberalization, see Cargill and Royama, 1990, and GAO, 1996.

[80]GAO, Japan, 1996, p. 22.

[81]Goodman et al., 1984, p. 100.

[82]Bear, 1990.

[83]GAO, 1996, p. 23.

[84]Sapsford, 1995.

Insurance and real estate activities are determined by home country and host country consent based on suitability of the shareholders. In general, however, the universal banking model has been adopted, with bank investments in industrial firms and industrial firm investment in banks permitted with some restrictions.[85] The EU approach has been reflected in changes elsewhere. For example, banks in Canada now offer security, insurance, and real estate activities through wholly owned bank subsidiaries. They are permitted up to a 10 percent interest in industrial firms, with aggregate shareholdings not to exceed 70 percent of bank capital. Industrial firms are permitted to hold up to a 10 percent interest in banks.[86]

2.5 Cross-Country Issues

The above review indicates a very long history for restrictions on banking activities, in a variety of circumstances and under different political regimes. It suggests that unique institutional imperatives have resulted in different types of development, and indicates the profound role of governments in determining the nature and extent of such restrictions.

The review also makes clear that law and regulation do not necessarily provide a realistic picture of the relationship between banking, commerce, and governments. Neither the United Kingdom, Germany, or Japan are quite what they seem. Banking practice in the United Kingdom is more restricted than law and regulation suggest; in Germany and Japan it is less restricted than law and regulation suggest.

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[85] Institute of International Bankers, 1995, p. 10; Barth et al., 1997, table 4.

[86] Institute of International Bankers, 1995, p. 8.

In the U.K. and the United States, relatively free capital markets developed to provide the financial resources for industrialization. Capital market development was associated with a rising mercantile class; government played a limited role. Germany and Japan were latecomers to industrialization, and their governments adopted policies to catch up. Private banking organizations provided a substitute for capital markets and a tool for what is currently called "industrial policy."

Once started on a distinctive path, banking and financial markets in different nations developed in distinctive ways. The resiliency of the systems that developed is apparent in the events following the collapse of Germany and Japan in World War II. It is sometimes suggested that socio-political factors have determined the differences that exist. The causal relationship may also run the other way; the systems, once in existence, may have cemented socio-political differences.

Whatever the cause of the differences, they are of degree. Close relationships among the government and banks, and among banks and commercial firms can be found in Great Britain and the United States, as well as in Germany and Japan. Nevertheless, the differences have had important consequences for the operations of the respective banking systems and, as discussed in the next sections, possibly the economy as well.

3. REVIEW OF POLICY ISSUES

A variety of issues are raised by the prospect of eliminating barriers between banking and commerce. The issues are classified and discussed below. The first subsection deals with issues that

arise out of possible effects in the financial sector, and the second with those in the "commercial sector." The first subsection discusses banking and financial markets issues. The second subsection focusses on economic stability and growth, competition, and other allocation efficiency issues. The third and fourth subsections review central banking and supervisory questions. The last subsection of the review addresses socio-political and cultural issues, with a focus on attitudes toward "bigness" and the role of government. The review is followed by an analysis of the issues as a whole and suggests some problems with their evaluation.

3.1. Banking and the Financial Sector

Many of the same banking and financial sector issues that arise in bank expansion into the securities and insurance businesses arise in merging banking and commerce. In general, those that have been extensively reviewed in recent years are discussed briefly below. Others are discussed in more detail.

3.1.1. *Portfolio Risk*

Permitting banks to acquire more substantial equity holdings than they can now could diminish the risk taken by banks or increase it. Economists and regulators have long understood that the riskiness of returns on common stock exceeds that of debt, other things being equal. For many years, a principal reason for separating banking from commerce has been the belief that some activities, including equity and real estate investment, were too risky.[87]

[87]See, for example, *Harvard Law Review*, 1920, for the reasoning in late nineteenth century court decisions restricting national bank powers.

It is now well understood that risk can be reduced by diversification. Equity and other types of assets might, in themselves, be relatively risky, but if they have a diversifying effect on other investments, they can reduce risk in a portfolio of assets by smoothing revenue streams over time. So, for example, a banking conglomerate that included an automobile manufacturer might find that, although interest rate increases during an expansion reduced revenues from financial services, the reduced revenues were offset by increased revenues from automobile sales. Alternatively, in a steep recession, with revenues from automobile sales declining, the offset might come from favorable interest rate spreads on financial services.

According to empirical evidence, diversifying by combining banking and commerce may reduce risk.[88] The potential, however, is likely to differ among banks of different size. So, for example, the potential gain for large banking organizations with international operations that already permit equity investments is unlikely to be as great as for smaller regional and local banks whose current investments opportunities are more limited. Moreover, whether or not a banking organization actually chooses to diversify will depend on more factors than the scope of permitted activities. There is also evidence indicating that widening the scope of permitted activities through holding companies has increased the volatility of bank returns.[89]

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[88] See Saunders and Yourougou, May 1990; Eisenbeis and Wall, May 1984. Empirical studies have shown that banks are currently highly diversified institutions and can shift a substantial portion of their portfolios at low cost to take advantage of opportunities to increase profit or reduce risk. See Boyd, Hanweck, and Pitharycutyl, 1980, and Boyd and Graham, 1988.

[89]For a review of these studies, see Mester, May/June 1992, p.22.

Regulatory and other factors affecting bank willingness to accept risk play a role. Regulatory and other factors affecting bank willingness to accept risk play a role. For example, the capital requirements imposed by the FDIC Improvement Act of 1991 (FDICIA) could make the acceptance of additional risk more costly, and alter the volatility results indicated above. Regulation to encourage banks to limit risk may be necessary because investors in bank stock will not necessarily value risk reduction through diversification as long as banks are protected by deposit insurance and other elements of the federal "safety net." To the extent protection is limited, investors can diversify in financial markets.

3.1.2. Economies of Scale and Scope (Real economies)

Eliminating barriers between banking and commerce could conceivably yield economies of scale and/or scope. Economies of scale are manifest in lower average costs when the scale of production of a specified product increases. Economies of scope lower average costs when different products within one organization share inputs. Realization of such economies for a wide range of banking services would, under competitive conditions, reduce prices paid by bank customers.

Combining banking with commercial firms makes bigger organizations. Big diversified organizations could increase scale if some of the products of the combining firms were enough alike to use the same production process, e.g., a bank's automobile financing and an automobile company's automobile financing.

Liberalization of branch banking restrictions in recent years has facilitated large scale without the involvement of commercial firms. By acquiring a small bank, a large bank can reduce the other's high average costs.

Modern investigation of scale economies in banking is about 35 years old. Current estimates suggest that bank growth to between $100 million and $1 billion in assets is likely to achieve scale economies and that large banks may suffer from diseconomies.[90] One of the disturbing characteristics about such studies, however, is that most of the variation in estimated efficiency remains unexplained.[91] To the extent such estimates are accurate, however, smaller banks rather than larger ones have substantial incentives to improve efficiency.

For producing benefits from combining banking and commerce, economies of scope are more promising. If such economies exist, they can best be realized in one organization or, if in subsidiaries or affiliates, in the absence of impediments created by corporate separateness and firewalls.

In general, meaningful economies of scope have not been detected by economic research.[92] A 1987 study found significant cost complementarities between several bank products (e.g., real estate loans and consumer loans), but insignificant economies of scope overall.[93] It also reported evidence that large banks had diseconomies of scope, suggesting that they could reduce costs by changing their output mix, something they may have done in the late 1980s and early 1990s. Studies of U.S. banks have not, however, included commercial activities that have been prohibited and could, conceivably, alter the findings.

3.1.3. New sources of capital.

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[90]See Hanweck and Shull, 1997, for a review of recent studies.

[91]Berger and Mester, 1997.

[92]Saunders, 1994, pp. 233-34; Saunders and Walters, 1994, pp.69-83 .

[93]Berger, Hanweck, and Humphrey 1987.

Through much of the 1980s, it appeared that the cost of capital to banks was high and that the cost prevented banks from obtaining sufficient capital to meet the levels desired by the federal regulatory agencies. The Treasury Department, in its 1991 report on *Modernizing the Financial System,* proposed that commercial firms be permitted to own financial conglomerates that included banks. It argued that:

> (c)ommercial companies have been an important source of capital, strength, management expertise, and strategic direction for a broad range of non-banking financial companies as well as thrift institutions. More important, banks need capital . . . .The case for allowing combinations of banking and commerce is particularly compelling in the context of permitting commercial firms to acquire failed banks. In some circumstances, substantial losses to the government from a failed bank might be avoided . . . .the pool of available buyers (currently) . . . may be very small if it is limited only to financial services companies.[94]

By the time of the Treasury report, the savings and loan problems and the passage of the Financial Institutions Reform, Recovery, and Enforcement Act in 1989 (FIRREA) had clarified the high cost of bad management, low capital, and high failure rates to the deposit insurance fund and taxpayers. The Treasury's argument, while maintaining the importance of corporate separateness and firewalls, of necessity implied a sufficiently porous "corporate veil" to permit the flow of capital from commercial firms, as required, to affiliated banks. In this sense, it was in tune with the cross guarantees provisions of FIRREA and source of strength doctrine of the Federal Reserve.

The immediacy of the need addressed by the Treasury has disappeared in the banking recovery of recent years. Since the early 1990s, the bank failure rate has diminished to insignificance, bank profits have been at unusually high levels, and bank capital ratios have been elevated. Market values of

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[94]U.S. Treasury Department, 1991, pp. 56-57.

large banks have risen well above book value. Moreover, interstate branching, not permitted at the time of the Treasury's report, now makes possible mergers that should substitute strong for weak managements. The objectives of the Treasury's proposal appear to have been met within current institutional restrictions.

3.1.4. *Conflicts of Interest*

The possibility for multiple conflicts of interest when a bank is an owner of the company to whom it is lending, or whose securities it is underwriting, raise issues that have a long history.[95] Among other things, the creditor-underwriter-owner combination also raises questions about the availability and use of insider information. Potential conflicts that have been cited from time to time include the following:

(1) A bank may extend credit to a company in which it has an ownership interest, independent of the company's creditworthiness, to assist the company and increase the value of its stock. Such an extension would conflict with the interest of its depositors, its safety and soundness, and the integrity of the deposit insurance fund. Further, rival companies, unaffiliated with the banking organization, might be subjected to unfair credit terms.

(2) If bank managers own, in their own right, equity in the same commercial company that the bank controls, managers would have an incentive, independent of the interests of the bank's stockholders, to increase the value of the company, possibly at the expense of the bank. The conflict, in this case, is between the interests of bank management and the bank's stockholders.

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[95]See, e.g., Pujo Report, 1913; Pecora Report, 1934; Peach, 1941; *Investment Company Institute v. Camp* 401 U.S. 617 (1971); Gessler Report, 1979.

(3) Similarly a bank may purchase the debt or equity securities of a company that it owns and to whom it is a creditor to temporarily increase the value of a company's stock and, in the extreme, provide it with funds to repay its bank loans. Such transactions would also conflict with the interests of depositors, safety and soundness, and the integrity of the deposit insurance fund.

(4) A bank may come to the rescue of a failing company by moving bad assets from its subsidiary or affiliate to the bank. It may or may not be a rational shift aimed at protecting the banking organization's reputation and future profitability.[96] The potential conflict in this case is between the interests of the bank's stockholders, on the one hand, and the interests of its creditors, bank supervision, the deposit insurance fund, and taxpayers on the other.

(5) A bank may obtain substantial amounts of inside information that it might act on in its security dealing. If the information is withheld from its securities customers, the bank could benefit at their expense. In the extreme, the bank may use inside information to sell weak securities from its own portfolio to its customers, either directly or through a managed investment fund, and to purchase strong securities in advance of publicly available information. The conflict between its own interests and the interests of its securities customers may be exacerbated by a conflict, under current law, between the requirement that it not reveal or act on inside information and the obligation of a dealer to provide all relevant information to its customers.

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[96]See Cornyn et al., 1986. Failure of one subsidiary or affiliate may affect the public's perception of management competence and the soundness of other parts of the organization. The changed perception may result in lower credit ratings and raise rates for borrowed funds.

(6) A bank, in controlling or influencing a commercial company's operations, may manipulate its borrowing, service contracts, and dividend policy to the detriment of the company's other creditors. It could conceivably reduce bank lending to the company and drain the company's resources through dividends and servicing-fee agreements.

In addition to the potential damage imposed on the disadvantaged side of such conflicts, each can be translated into potentially unfair methods of doing business. The implicit assumption throughout is that there are incentives to engage in such practices and that those on the disadvantaged side are not able to protect themselves adequately. Small depositors and investors are the most likely victims.[97] However, competition, transparency in the bank's interests and operations, and the bank's own long-term concern for its reputation may answer some of the concerns. A review of alleged conflicts at large German banks was undertaken by the Gessler Commission in the late 1970s. The commission found many of these potential conflicts of little practical significance.

Conflicts may be exacerbated by the organizational form. In either an affiliate or subsidiary structure, ownership and creditor relationships between a bank, its officials, and the subsidiaries or affiliates are likely to be important.[98] Universal banks, in which all activities are conducted within the bank itself or in subsidiaries or affiliates that are owned pro rata by the organization's stockholders, carry the least danger of creating incentives that exacerbate potential conflicts.

3.1.5. *Global Competition and Bank Viability*

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[97]F. Edwards, 1979.

[98]Shull and White, 1997; F. Edwards, 1979; Walter, 1996, pp. 29-30.

If narrowing or eliminating the separation between banking and commerce reduces risk, moderates the asymmetric information problem, and, for these and other reasons, lowers average costs, foreign banks with broader powers should have an advantage in competition with U.S. banks. If nothing more, foreign banks should have an advantage in maintaining loan customers in whom they have an ownership interest.

The rapid growth of foreign banks in the United States, both before and after the International Banking Act of 1978, gave some credence to this contention. So did the loss of large commercial customers to the commercial paper market in the 1980s and the relatively rapid growth of nonbank financial institutions.

The competitive importance of commercial combinations, however, is not clear. There is little empirical work on the issue. One recent study indicates little difference in profit performance between U.S. banks and foreign banks.[99]

3.1.6. *Financial Markets*

As discussed in sections 2.4 and 2.5 on banking developments in other countries, comparisons suggest that financial markets are less developed in countries in which banks have played a larger role in providing equity and long-term credit as well as short-term credit. It has frequently been suggested that because many transactions in Germany were executed through banks rather than through markets, universal banking has been at least partly responsible for Germany's weak capital markets.[100]

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[99]Barth et al., 1997.

[100]Goodman et al., 1984, pp. 88-90. See also Gessler Report, 1979, p. 105.

In the mid-1980s, one study of capital markets in Germany reported signs of "fragmentation." The size of issues were small, turnover was relatively low, the market was shallow, and the market's formal operations were limited. The German banks' role as "an all purpose financial institution, the absence of large non-bank financial institutions, the banks' freedom to invest in equities and the German tax system," it concluded, "may all contribute to the country's narrow capital market development."[101] Comparing developments in the United States, Canada, the United Kingdom, and Switzerland, as well as Germany, the study inferred a positive relationship between product-line restrictions for banks and capital market development.[102] More recently, it has been suggested that European union, which entails development of the Euro, is likely to stimulate European money and capital markets and to make commercial paper and bonds more serious competitors for bank loans.[103]

3.2. Production Sector

Prospective banking/commerce changes may directly affect not only the financial sector but also the commercial or production sector of the economy. Potential impacts can be considered in a number of areas, including economic growth and stability, competition, concentration, and small business lending. There are, moreover, a variety of other allocational efficiency considerations that also merit attention.

3.2.1. *Growth and Stability*

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[101]Goodman et al. 1984, p. 90.

[102]Goodman et al., pp. 104-5.

[103]McCauley and White, May 1997.

The relative contributions of banking-commerce relationships to economic growth and stability has been a focal point of comparison between Germany and United States. The cost of capital to commercial firms, the pace of innovation and technological change, and susceptibility of the different economies to systemic events all have potentially differential effects on economic growth and stability.

3.2.1.1. Asymmetric Information, Transaction Costs and the Cost of Capital. Commercial borrowers typically have more and better information about their business than anyone else, and often better information than a lending bank. In any creditor-debtor arrangement, dissimilar incentives for each party exist. For example, on the basis of private information, the borrower may project a declining demand for his product over the next year. But the borrower has no incentive to reveal this to the bank, knowing that it could affect the amount and terms of his borrowing. A bank in these circumstances is compelled to make expenditures to obtain the best information it can and to monitor the borrower; it will try to write a contract that protects it from the possibility that demand for its borrower's product will be lower than it projects. The problem of "asymmetric information" is likely to be exacerbated when a borrower nears default.

If, however, the bank has sizeable equity holdings in the borrowing firm, obtaining good information and monitoring the borrower is likely to be cheaper. If its equity holdings are sufficient to control the borrowing firm in what amounts to vertical integration, the problem disappears. In this way, narrowing the separation between banking and commerce could permit banks to economize on information costs and thereby reduce the cost of borrowing.

More generally, the issue is one of transaction costs that are viewed as determining, short of government intervention, how firms are organized. It is generally viewed as good economic policy to let

firms determine what combination of products they will produce, so as to conserve resources by reducing transaction costs.[104]

Traditionally, economists viewed the boundary of the firm as given by technology. One kind of technology created companies that produced steel; another, companies that manufactured automobiles, etc.[105] A modern insight of economic analysis has been that a company's boundaries are determined by transaction costs which determine when a firm will sell its output in the market or when it will transfer it to an affiliated unit which may, in turn, sell it.[106] Vertical integration implies the elimination of contractual exchanges in markets and the substitution of internal exchanges within the firm.

Vertical integration, including the integration of a bank with a commercial customer, may be a way of reducing transaction costs associated with necessary cooperation between the transacting parties. The costs of cooperation, including costs of planning, adapting, and monitoring, could be reduced by integration.[107]

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[104]The analysis of transaction costs in this section draws on Shull, Winter, 1993. More extensive notes and citations can be found there. The early development of the economics of transaction costs can be found in Commons, 1934 and Coase, 1937. See Williamson, 1989.

[105]Williamson, 1989, p. 150.

[106]Coase, 1937.

[107]Underlying transaction costs is "bounded rationality," which holds that individuals "are limited in knowledge, foresight, skill, and time." Bounded rationality implies that contracts will have implicit elements and thus be incomplete. In other words, neither law nor regulation can spell out precisely how each party will behave in all possible circumstances relevant to the relationship. The implicit elements include informal "understandings" about behavior, particularly regarding unspecified contingencies that affect the net benefits of both parties. Self-interest, with incomplete contracts, can lead economic agents to intentionally mislead, distort, obfuscate, and confuse (Williamson, 1989, p. 139). The issues that arise have been variously described as opportunism, moral hazard, and the principal-agent problem.

Under current banking law in the United States, bank relations with commercial customers must be carried on through a variety of contractual agreements. They are characterized by a nexus of current transactions and future commitments that involve, among other things, existing loans, credit lines, deposit balances and a variety of other banking services. They typically include "conditional agreements" that hinge the provision of one service (e.g., credit) on the purchase of another (e.g., deposits).

Pricing reflects the varied combinations of services provided and/or expected to be provided. For the bank, a number of the products are jointly produced (e.g., various types of loans, deposits, and other closely related services such as loan commitments); providing them in combination may reflect economies of scope or a response to customer demand.

For the customer, many bank products are complementary, and their combined purchase may simply reflect reduced costs of information-searching and shopping, i.e., lower transaction costs for customers, typically termed "convenience." From the bank's point of view, these reduced costs for customers are sometimes labeled "organizational economies of scope" that produce lower average marketing costs through cross-selling related products.

The customer relationship, including loan agreements with long-term customers, may therefore reduce transaction costs. But loan agreements are limited by law and regulation, and the arrangements are not costless. The agreements require relational-specific investments and are typically incomplete and subject to principal-agent problems. Customers invest time, effort, and private information, as well as fees, in banks they expect to provide essential financial services indefinitely and to forgo "holding them

up" in time of need. Banks invest in particular customers by learning their business, evaluating their needs and capacities, and accommodating specific loans into their portfolios.

The complexity and variety of possible contingencies in such relationships invariably make the customer relationship an *incomplete* agreement. Many lenders' rights and borrowers' obligations are specified in detail. But uncertainties inevitably remain, particularly when the probability of default increases beyond some threshold. Rights and obligations when the likelihood is high that a loan will default are not well specified. The variety of possible circumstances surrounding imminent default preclude any specification of the restructuring option in the original contract.[108] Nevertheless, when default looms, it is often in the interests of both parties to restructure.

There is no reason to believe that the formal and informal agreements that comprise the customer relationship are injurious to competition in financial markets. The private information a bank obtains in dealing with loan customers permits it to develop better default estimates than those available to competitors. It may achieve a competitive advantage that, at least temporarily, provides extraordinary profits. At the same time, rival banks have an incentive to attract borrowers by charging prices below direct cost in expectation of higher future profits after a relationship has been established. Lower quality borrowers, not readily distinguished by competitive banks, are likely to be benefitted. In

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[108]One result of this kind of contracting, as a substitute for vertical integration, is the conditional agreement, e.g., tying and reciprocal arrangements. Collateral, for example, is an obvious reciprocal condition that would not be necessary in an integrated banking-commercial enterprise. Deposit balances may serve as informal collateral. One purpose of such agreements, aside from the obvious use of collateral to reduce credit risk, is that banks can obtain timely information on the course of a borrowers' business from their use of payroll, data processing, insurance, and underwriting services. They also provide a basis for estimating future customer profitability that could serve both the bank and its customer in periods when profitability diminishes.

a competitive banking system, even with conditional agreements, zero expected profits would be expected over an infinite time horizon.[109]

The questions of excessive transactions costs and inefficient use of resources, however, do not go away as a result of competition. Long-term agreements are probably more easily sustained in the universal banking system. Costs may decline as the result of a decrease in firm-specific investment, as discussed in connection with the asymmetric information problem. Integration can also be viewed as a way of obtaining the results of "complete contracts," in part by reducing the costs of contract renegotiation and threat of "hold-ups."[110]

Both asymmetric information and transaction cost analysis suggests that acquisitions of commercial firms by banking organizations would lower banks' cost of capital. It has recently been argued that the United States sacrificed growth, from the beginning of this century on, because it disallowed universal banking; the German universal banking system provided capital at a lower cost.[111] The rapid economic growth of Japan and Germany, both before and after World War II, has also suggested that economic advantages derive from close, long-term relationships between large banks

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[109] See Greenbaum, Kanatas, and Venezia, note 15, pp. 222-23. Avoidance of this result would seem to imply collusion not only to set uniform "prices" but also to constrain customer movement from one bank to another. Customer defections, for whatever reason, impose losses on the old bank (loss of specific investment and search costs) and additional costs on the new bank (specific investment in the new customer) which could undermine a price agreement. The territorial division of customers, in addition to price agreements, were customary in banking during the period of government-sanctioned competitive restrictions from the 1930s through the 1950s.

[110]Bisignano, 1992, p. 19.

[111]Calomoris, 1993, 1995. Law and regulation, he suggests, proscribed what could have developed into universal banking through the efforts of investment bankers, in particular, J. P. Morgan.

and large commercial firms. For example, such combinations are said to solve the asymmetric information problem. The smoothing of credit rates of interest at relatively low levels over the life cycle of a firm may require the stable, long-term banking relationships characteristic of universal banks.[112]

In the late 1980s, a number of studies found differential costs of capital for corporations in the United States and in other countries. One found that the cost of capital in the United States was higher than in Japan.[113] Another found the cost in the United States and Britain was considerably higher than in Germany and Japan.[114] The latter study concluded that the lower cost of capital in Germany and Japan was due not only to close relationships between corporations and banks but also to government efforts to reduce the private costs of business distress.

The traditional economic argument that growth is best served by free capital markets, involving objective evaluations of risk and arms-length transactions, rather than bilateral negotiation between vertically affiliated suppliers and demanders of credit, has thus been challenged. However, the quantitative significance of the differential banking characteristics in the United States and elsewhere remains uncertain. The role of government in accepting risk that would otherwise be incurred by private firms may be critical. Unraveling the private from the public factors determining the differential costs of capital remains a difficult, if not intractable, problem.

3.2.1.2. Technological change and innovation. Technological improvements and innovation accounts, through improved productivity, for a substantial share of economic growth in

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[112]Calomoris, 1993, pp. 9 ff..

[113]Porteba, 1991, pp. 20-32.

[114]McCauley and Zimmer, 1989, pp. 7-27.

the United States. It is conceivable that larger and better diversified banks would contribute to more rapid technological innovation. Large companies have an advantage in supporting research and innovation; diversification might contribute because of the "cross fertilization" of ideas and the cross-selling of new products, among other things.[115] How important size and diversification are, however, is unclear, given the possibilities for sluggishness in large, complex organizations and the seeming willingness of small and new businesses to take greater risks.

The combination of banking with commercial firms will result in larger and more diversified organizations. Improved efficiency and lower costs of capital, if they materialized, might better support innovation both in banking and in industry. There has, however, been little or no investigation into the effects of bank size and diversification on innovation. In other areas, empirical studies have not provided consistent results.[116]

3.2.1.3. Systemic Risk. Concern about systemic risk transcends the financial and commercial sectors. To the extent a systemic event develops in any sector, it is likely to affect the entire economy.[117]

The ability of banking organizations to diversify could provide some protection against distress that might otherwise lead to systemic problems. The Canadian banking system, whose widespread

[115]Scherer and Ross, 1990, p. 659.

[116]Scherer and Ross, 1990, pp. 659-60.

[117]For a definition of systemic risk, see Bartholomew, Mote, and Whalen, 1995. Most definitions of systemic risk include a presumed likelihood that a development or event will cause bank failures that result in system-wide disruption, and some idea about the unexpected nature and the magnitude of the precipitating development or event.

branching permitted geographic diversification, has often been cited as less vulnerable to the crises of the 1930s than the “unit banks” of the United States. The extent to which other factors played a role is unclear.

Whatever the extent of geographic and/or product diversification, systemic problems may still occur, for example, from oil crises, stock market crashes, and real estate busts; that is, from the kind of risk that cannot be reduced by diversification. The timing and specific nature of such shocks are not predictable.[118] Less bank aversion to risk at the end of a long expansion has been identified as a contributing cause of systemic problems.[119] Objectively, shocks become increasingly likely with the lengthening of an economic expansion in which optimism flourishes.[120]

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[118]See Guttentag and Herring, 1986, pp. 2, 32-33. They define "shocks" as low probability hazards carrying high potential costs.

[119]Minsky, 1986; Guttentag and Herring, 1986. Minsky argues that there is a tendency for a deterioration in the quality of credit, reflected in debt and debt service requirements, which increase relative to historic (as opposed to expected) cash flows. Memories of past failures dim and are seen as irrelevant. New financial and industrial technology and new government policies, during periods of prosperity are conducive to the idea that the future will not be like the past. Over such periods, banks can become increasingly fragile.

[120]Guttentag and Herring, 1986, pp. 3,4. Bank managements, however, have little basis on which to calculate the probabilities that a systemic event, such as an interest rate shock which raises funding costs relative to asset returns, or a default on assets that make liabilities unfulfillable, will occur. They appear to operate as if the likelihood of such events is zero. Banks that attach a prudent probability to their occurrence and attempt to operate more conservatively during the expansion are faced with the prospect of losing business to competitors that do not attach an appropriate risk premium to their credit extensions to build up a reasonable reserve. Guttentag and Herring cite evidence in the psychological literature to suggest that when a probability reaches some critically low level, it is treated as if it were zero.

In the late 1960s, Minsky referred to this phenomena as "the economics of euphoria"; more recently, Guttentag and Herring have labeled it "disaster myopia."[121] It can also be generated by severe monetary restraint that abruptly elevates market rates of interest, as was the case in the United States in the early 1980s.

Systemic problems resulting from risks that cannot be diversified away could be greater in a universal banking system for two reasons. First, combined organizations that were affected would constitute a larger share of financial and economic activity and are likely to leave larger portions of the economy exposed. Second, closer connections between banks and commercial firms is likely to transmit shocks more easily, for example, through a drop in stock prices and possibly through internal shifts in resources.[122]

Empirical evidence is lacking, however, on whether systemic problems are exacerbated by banking/commerce affiliations, whether shocks are likely to reverberate more extensively through one type of system or the other, and whether or not shocks are more easily resolved in one kind of system or the other.

3.2.1.4 Risk-sharing and intertemporal smoothing. The existence of systemic risk raises the issue of risk-sharing. It is a well-established principal of modern financial

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[121]The onset of a shock may be due to the inability of one or more large banks to replace volatile liabilities (e.g., as might have occurred without banking agency intervention in the failures of banks in the United States like Franklin National in 1974, Continental Illinois in 1984, and Bank of New England, 1991). In these cases, the FDIC and/or the Federal Reserve behaved as if they believed that failure posed a systemic risk.

[122]A related problem, involving possible extension of the federal safety to commercial businesses affiliated with banks, is discussed below in section 3.3.

analysis that well-functioning financial markets permit portfolio diversification and reduction or elimination of the risk associated with variability in the return to individual securities. Further, financial markets permit the adjustment of portfolio risk in accordance with preferences, as well as the hedging of risks. Diversification, portfolio adjustment, and hedging involve the exchange of risk among market participants. They can be termed "cross-sectional risk-sharing," since "different individuals are exchanging risks at a given point in time."[123]

On the other hand, there are important kinds of risk that, as a practical matter, cannot in general be diversified or hedged. These include risks that arise out of shocks that affect the entire economy, such as the oil crisis of the early 1970s and the sudden and substantial upward movement in interest rates in the early 1980s. These kinds of risk can be reduced, however, through institutional mechanisms that stabilize investors' income streams over time. Such mechanisms also involve risk-sharing that can be termed "intertemporal smoothing."[124]

In the United States, financial markets facilitate cross-sectional risk-sharing but do not provide intertemporal smoothing. Some smoothing, however, takes place when the social security system and budget deficits reallocate resources among generations. Universal banking, as it has existed in Germany, has probably discouraged the development of financial markets and therefore cross-sectional risk-sharing. Experience suggests that the banks have shared intertemporal risk by building high levels of

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[123] Allen and Gale, 1996, p. 533.

[124] Allen and Gale, 1996, p. 533-34. It is, of course, possible for investors to protect themselves against such risk by investing only in safe, short-term assets such as Treasury bills or U.S. savings bonds, i.e., by "opting out." As they do, they forgo potential gains in the financial markets and reduce the ability of the markets to provide cross-sectional risk-sharing.

reserves in good times and running them down in bad. The principal asset in which individuals are likely to invest is debt, in particular the debt of banks.

Which system is superior for resource allocation or investors is unclear. While there is a temptation to assume that the two systems might be combined so that both cross-sectional and intertemporal risk-sharing is provided in accordance with investors' preferences, it is uncertain whether universal banking and well-developed financial markets can coexist. It has been suggested that universal banking will not survive in the presence of financial markets.[125]

3.2.2. *Competition and Concentration*

How combining banking and commerce would affect competition and concentration are longstanding concerns. In the following sections, the issue is discussed generally. Following that discussion is one on closely related issues involving small business lending and the role of government.

3.2.2.1. General discussion. In the fourteenth century, Venice prohibited its banks from dealing in certain commodities, plausibly to prevent their monopolization; in the seventeenth century, England prohibited the newly chartered Bank of England from dealing in merchandise "to the intent that her Majesties subjects may not be oppressed by the said corporation by their monopolizing . . . any sort of goods, wares or merchandise . . . ." Following the English tradition, similar prohibitions were imposed on the earliest chartered banks in the United States.

This long tradition of separating banking and commerce is in contrast to the German and Japanese tradition of cartel-like organizational structures. An early study in Germany reported extensive

[125] Allen and Gale, 1996, pp. 540-42. See also comments by Mester, 1996, p. 543.

interlocking directorates between banking and industrial companies, reflecting a community of interest that contributed to the growth of some of the German industrial giants.[126] The well-known economic historian Alexander Gerschenkron saw German developments in the latter part of the nineteenth century as follows:

> . . . the banks were primarily attracted to certain lines of production to the neglect, if not the virtual exclusion, of others . . . . [I]t was essentially coal mining, iron- and steelmaking, electrical and general engineering, and heavy chemical output which became the primary sphere of activities of German banks . . . . [I]t was heavy rather than light industry to which the attention was devoted. The last three decades of the nineteenth century were marked by a rapid concentration movement in banking . . . . The momentum shown by the cartelization movement of German industry cannot be fully explained, except as the natural result of the amalgamation of German banks . . . . The banks refused to tolerate fratricidal struggles among their children . . . . [T]hey were at all times quick to perceive profitable opportunities of cartelization and amalgamation of industrial enterprises.[127]

Gerschenkron acknowledged that after the turn of the century in Germany, the "ascendancy of the banks over industrial enterprises could no longer be maintained." Industrial giants began to use more than one bank and even to establish their own banks, but there remained "the close relation between banks and industry, even though the master-servant relation gave way to cooperation among equals and sometimes was even reversed."[128]

Between 1920 and 1945 in Germany and Japan the banking-commerce systems were characterized by a relatively few large and diversified conglomerates that came in contact with one another in large numbers of markets. These conglomerates seemed to have found ways to coexist by

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[126] Jeidels, 1905.

[127] Gerschenkron, 1962, p. 15.

[128] Gerschenkron, 1962, p. 21.

replacing competition with negotiation. Corwin Edwards, who served as director of a U.S. mission to investigate the Japanese zaibatsu system after World War II, argued that each large firm recognized priorities of interest with respect to other large firms in hope of reciprocal recognition and out of concern for retaliatory actions. A cooperative spirit of mutual forbearance was cultivated.[129]

This analysis produced the hypothesis that multimarket contacts among large organizations facilitate the adaptation and spread of collusive strategies, resulting in higher levels of industry profitability and offsetting gains in economic efficiency from diversification. It was thought that such organizations have a different competitive attitude toward one another than they do toward smaller, undiversified businesses.[130] There has been some empirical support for this hypothesis in recent years.[131]

In large part, concerns of this kind motivated passage of the Bank Holding Company Act of 1956 and its 1970 amendments. The 1956 act prevented a holding company from being used by banking organizations to acquire commercial firms and to enter activities prohibited to banks

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[129]C. Edwards, 1955; Scherer, 1970, p. 278. Edwards argued that with respect to small firms, their size and diversification gave large firms "deep pocket" advantages that permitted them to impose competitive injury. In consequence, smaller firms had to take into account the policies of the larger firms and hope for some degree of generosity or at least indifference. As diversification increases, large firms may even have less market power in individual markets but more links with other large firms that support the need for mutual forbearance. Their size, rather than relative market position, is the source of their advantage over small firms.

[130]Hughes and Oughton, 1993, p. 211.

[131]See, however, Calomoris, 1993 p. 29. He argues that universal banking was neither a necessary nor sufficient cause of the cartelization of German industry, that "the role of (financial) intermediaries in developing and enforcing industrial cartels remains a murky area in economic history," and that ". . . allowing a concentrated universal banking in the United States during the pre-World War I era would have had little marginal effect on concentration."

themselves. The 1970 amendments closed the one-bank loophole (although providing for expansion into closely related businesses).

Congress' concerns about how banking conglomeration would affect competition and concentration were clearly articulated. The "net public benefits test" established by the 1970 amendments required the Federal Reserve to evaluate the effect of any proposed activity on concentration and competition.

The current significance of the concerns that motivated holding company legislation in 1956 and 1970 depends on a number of questions not easily answered. The first set deal with whether the current intensity of competition will be sustained as much larger and more complex banking organizations develop. How many "Great Banks" will there be? Will they compete or collude, or will their behavior be some combination of the two, as apparently was the case in Japan? How will they interact with small banks in local markets, who may or may not be at a substantial disadvantage?

A second set of questions involve prospects for small and new businesses not affiliated with major banking organizations. Will they have less access to credit than rivals who are affiliated with banks, and, when they obtain credit, will their rates be higher? Differentially higher rates for nonaffiliated businesses is the other side of the asymmetric information problem discussed above. There is, in fact, no easy way to distinguish between higher rates attributable to higher costs (including risk), on the one hand, and to market power, on the other. Will higher rates compel most businesses to affiliate with banks if they can?

The final set of questions deal with the relationship of large banking organizations with government. Will their size and importance compel government to protect them when, and if, they

confront difficulties? If economic conditions deteriorate, as they do periodically, will government be more tempted to formulate industrial policy because large organizations combining major banks with major commercial firms provide a convenient mechanism for directing the allocation of financial resources in seemingly advantageous directions?

Some analysis is possible in addressing the above questions, but it does not permit definitive answers. Further empirical work is needed.

3.2.2.2. Small business lending. A traditional criticism of universal banking in Germany and the close association between banks and commercial firms in Japan has been that small and new businesses are discriminated against in obtaining credit. This same criticism has periodically been made against large banks in the United States. A fundamental problem in evaluating such criticisms is that it is difficult to differentiate between the effects of business size and credit risk on differential rates, terms, and credit availability.

Recent empirical studies in the United States have indicated that there is a strong inverse relationship between size of bank and the extent of lending to small business, as a percent of bank assets.[132] There is some evidence that larger, more complex banks do not provide as much credit to small businesses.[133] There is also evidence that de novo banks make more loans to small business than established banks of similar size.

Even though combining banking and commerce, coupled with continuing mergers, will result in larger banking organizations, no issue need arise as long as adequate sources of credit remain for small

[132]See Goldberg and White, 1997, for a summary of the literature.

[133]Berger and Udall, 1996.

businesses. However, small businesses are typically more dependent on bank credit than large, and it is possible that the shifts now occurring will diminish the availability of credit to them.

3.2.2.3. Industrial Policy. Germany and Japan have, in the past, directed equity investments by banks to meet government objectives for industrialization and military preparation. Banks have been elements in their industrial policy.

In the United States, as reviewed in section 2.3, banks have also been used to meet public objectives. The scope of government involvement has, however, been more limited in the United States. Comparative experience suggests that universal banking is a useful mechanism for industrial policy.

While economic analysis strongly supports some government direction of resources, there have been in the United States, particularly during recessions, debates on whether government should identify and support key industries to enable them to compete in world markets. The integration of banking and commerce would not in itself resolve this debate, but it would create a convenient mechanism for such support.

3.2.3. *Other Allocation Efficiency Issues: Corporate Governance*

As discussed above in section 3.2.1 and 3.2.2, a universal banking system's asymmetric information/transaction costs and competitive imperfections may cause real resources to be allocated less efficiently. Corporate governance in a universal banking system can affect resource allocation for good or bad.

Wide distribution of stock ownership and the resulting control of corporations by managements create an agency problem that may result in improperly managed companies.[134] In such cases, resource allocation is improved by external discipline of one kind or another, including the credible threat of a change in control.

In the United States, management failures can be corrected by takeovers and buy-outs that rely on the existence of well-functioning capital markets. In universal banking systems, with less well-developed financial markets, the discipline may be internal; the management of commercial firms is constrained by bank shareholders whose representatives sit as directors on supervisory boards and who vote their own shares and have proxies for the shares of others with whom they have a fiduciary relationship.[135] So, the *Wall Street Journal* reported a number of years ago: "Nobody in Germany was surprised this summer when a Deutsche Bank AG executive stepped in to settle a management feud at Daimler-Benz AG and then took it upon himself to announce the outcome."[136]

There are resource implications in these two distinct methods of addressing the principal-agent problem in corporations. Further analysis would be useful.

3.3. Central Banking

Over the past decade, Federal Reserve spokesmen have objected to combining banking and commerce because of the possible extension of both Federal Reserve credit ("sovereign credit" in

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[134]Bisignano, pp. 26, 27.

[135]Franks and Mayer, 1990, p. 207.

[136]Roth, 1987.

Chairman Greenspan's terms) and the federal safety net to commercial firms affiliated with banks.[137] The Fed has indicated particular concern about the possible transfer of credit in times of stress, as well as the effects of credit and safety-net extensions on competition and concentration.

The issue of the extension of the safety net and whatever subsidy might be involved have been widely discussed over the past year in connection with financial modernization. No attempt is made here to review the debate.

The Fed's concerns, however, are puzzling because it presumably has the authority to price credit at the discount window and in the payments system at roughly market rates. Such pricing would diminish concerns about the extension of any subsidy and its competitive effects.

If the price of "sovereign credit" is not the basis for the Fed's position, what is? Presumably its availability. Federal Reserve "credit" (through reserve creation) is not only extended through the discount window and in the course of payments but also in open market operations when influencing interest rates. Such "credit" extensions, along with the level of reserve requirements set by the Fed, are a principal factor in determining the credit-producing capacity of banks.

In a "separated" banking system, the Fed can presume that the decisions it makes, regardless of interest rates, result in an allocation of financial resources on an arms-length basis through competitive financial markets in which banks participate. While its policies determine bank resources in the aggregate, markets rather than the Fed determine their allocation.

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[137] Volker, 1986, Corrigan, 1990, 1991, and Greenspan, February 1997.

A characteristic of universal systems has been that banks rather than the markets determine resource allocation. Under similar arrangements, the Fed could not escape the allocational implications of its reserve creation. So, for example, if it eased monetary policy, it might confront the complaint that it was doing so for the benefit of large commercial firms affiliated with large commercial banks. In times of stress, transfers of credit to commercial company affiliates or subsidiaries may be difficult to control. Further, to the extent that the imminent failure of a large banking-commercial organization precipitated serious problems for other banking organizations, the Federal Reserve and the FDIC might feel compelled, within the constraints imposed by FDICIA, to protect the entire organization.[138] In a universal banking system, the problem of avoiding decisions that directly involve resource allocation would be exacerbated if financial markets deteriorated.

Such concerns may be moot. A careful consideration of foreign experience would be illuminating.

3.4. Supervision

Relaxation of the barriers between banking and commerce raise several supervisory issues, some of which have been touched on briefly above. These include: (1) how the change will affect safety

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[138]See, for example, Volker, August 1986, p. 553. When Chrysler Corporation came close to failing in 1981, it was provided with direct access to the Federal Reserve's payment system facilities, including credit extensions. At the time, according to the then Chairman Volker, it had been placed "under government protection"; Congress guaranteed loans to the company. If Chrysler or a similar commercial firm were owned by Chase, or some other large banking organization, and its failure was imminent, access to Fedwire and the discount window by Chase might permit an extension of Federal Reserve credit to Chrysler without any Congressional guarantees. Whether or not this were the case would depend on the extent to which firewalls were sustained.

and soundness, (2) how the regulatory structure will be affected, and (3) whether bank regulation and supervision will be extended to nonbanking sectors of the economy.

3.4.1. *Safety and soundness*

How combining banking and commerce will affect risk, economies of scale and scope, bank capital, conflicts of interest, and competitive viability, discussed above, all have significant implications for the safety and soundness. Additional issues arise out of the practical problems of regulating and supervising organizations that control both types of enterprise. These include questions about the best bank organizational structure, the effectiveness of firewalls, cross-guarantees when banks are in difficulty, and the "too-big-to-fail" policy. These issues, which have been discussed extensively in connection with the expansion of banks into securities and insurance, will be reviewed briefly here.

3.4.1.1. Organizational structure of the universal bank. While all activities, whether they be financial or commercial, might be conducted within one corporation, in the United States it is far more likely that law and regulation will require commercial activities to be conducted in separately incorporated subsidiaries or holding company affiliates. The principal aim is to protect the bank from the risks involved in commercial activities and to prevent the transmission of whatever subsidy might exist for the bank to nonbanking activities. Firewalls are intended to bolster corporate separateness. The assumption is that firewalls are more effective between separate corporations than within a corporation (e.g., between a bank and its trust department).

3.4.1.2. Firewalls.[139] Are corporate separateness and firewalls effective? The consensus is that they tend to break down in extreme situations. There is, however, no comprehensive information that would permit empirical study.

Bank supervision notwithstanding, the effectiveness of separateness and firewalls is likely to depend on the strength of incentives to penetrate them. In any event, the supervisory burden would be lightened if incentives are diminished. Because the effectiveness of firewalls is an issue repeatedly raised in Congressional hearings on legislation to permit an expansion of activities for commercial banking organizations, a systematic evaluation of experience, and the likely influence of ownership structure and capital levels under current law and regulation, is needed.[140]

3.4.1.3. Too big to fail. FDICIA was intended to constrain banking agency support for large, failing organizations, but did not prohibit it. As banking organizations grow larger and more complex, financial markets and bank managers are likely to perceive some as being too big to fail. Such perception creates bank incentives to take excessive risk (moral hazard). Supervisors of banking organizations perceived as too big to fail are likely to depend heavily on risk-adjusted capital requirements for the bank (if not the banking organization), risk-adjusted deposit insurance premiums, and intensive supervision.

From a competitive perspective, too big to fail provides advantages to large banking organizations relative to small ones. Unless market perceptions are built on a clear understanding that

[139]The ideas in this section draw on Shull and White, 1997.

[140]The inadequacy of current information is discussed more fully in Shull and White, 1997, pp. 458-60

banks, but not their subsidiaries and affiliates, are supportable, and that strict enforcement of firewalls will be maintained, the "corporate veil" would not be adequate to prevent the transmission of too-big-to-fail advantages to commercial firms through lower organizational costs of capital.

3.4.2. *Organizational Structure for Bank Regulation*

A multitude of federal and state regulatory agencies has become the norm in the United States. Combining banking with commercial activities would at least require this multitude to work in a more coordinated fashion. Banks would likely enter businesses that are regulated by other types of agencies. Banks might own or be owned by public utilities such as telephone companies, transportation companies, oil/gas pipelines, and power companies. Expansion through separate subsidiaries or affiliates may bring so-called functional regulation S the regulatory supervision of a complex company by many agencies according to their expertise. Whether or not that happens, the continued existence of firewalls and any continuation of cross-guarantees call for close cooperation among the several bank regulators.[141] If combined banking-commercial organizations measure and manage their risk on a consolidated basis, another important reason exists for such cooperation.[142] If new banking-commercial combinations involve new interfaces between banking and nonbanking regulatory agencies, issues regarding the efficacy of the current regulatory structure, similar to those that have arisen in debates on bank expansion into securities and insurance, are likely to develop.

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[141]Cross-guarantees that aim to safeguard the deposit insurance funds constitute an expansion of liability for the stockholders of banking organizations. See Jackson, 1993, p. 406, and 1994, pp. 528 ff.

[142]Federal Reserve Board chairman Alan Greenspan has argued for more than cooperation and information-sharing. He sees a need for "umbrella supervision." See Greenspan, May 1, 1997. The arguments regarding "umbrella supervision" have been elaborated in recent Congressional testimony.

3.4.3. *Extension of Bank Regulation*

How will the banking agencies supervise and regulate combined bank-commercial firm organizations? Monitoring the operations and performance of commercial affiliates and subsidiaries alone would be relatively unintrusive. Understanding their operations and performance and how they relate to the bank is likely to require some experience and possibly more active "hands-on" examination. How much active involvement is necessary will likely depend on the effectiveness of firewalls and whether cross-guarantees exist. If regulators expect a commercial firm to support the bank that owns it, they must understand the commercial firm's condition.

The extension of bank regulation to unregulated areas of the economy would be costly. Concern about expanding bank supervision and regulation has motivated recent proposals for a "narrow bank." Such banks would eliminate the need for regulation by confining banks to safe and liquid investments, while permitting organizational expansion into any other activity. The assumption is that narrow banks would be immunized from other activities within their organizations because their limited portfolios would eliminate incentives to transfer bad assets to the bank.

3.5. Socio-political and Cultural Issues

In considering socio-political and cultural issues, definitions are useful. Political systems include the relationships between people and their political leaders, methods of choosing political leaders, and factors affecting political decisions. Social systems include group structure in society, relationships among groups, and the duration of such groups. Both political and social systems may be subsumed under the amorphous term "culture." Cultural characteristics include perceptions of and attitudes toward

social, political, and economic systems, leaders and groups, as well as other aspects of life. Culture would incorporate moral values and family values.

It is unusual to consider socio-political and cultural effects when considering bank deregulation. That they are raised as an issue, as they have been, is an indication of the unusual breadth of concerns about combining banking and commerce.[143]

Issues emanates from some of the possible institutional and economic changes considered above, in particular from the possibility that a small group of very large conglomerate banking organizations, with close ties to the government, will emerge.[144] From time to time, analogies are drawn to German and Japanese experience.

One extreme interpretation of this experience is reflected in the attitude of policy-makers in the United States after World War II. They believed a causal relationship existed between the concentrated commercial bank/commercial firm structures in Germany and Japan and the political and military policies of those two countries. Postwar policy aimed to dismantle the German cartels. It dissolved the three large banking corporations (Deutsche Bank, Dresdner, and Commerzbank) and allowed the establishment of 30 successor banks. These reemerged in 1957 as the reconstituted Big Three.[145] The Japanese zaibatsus were also broken up, but less formal ties remained; similar organizational

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[143]For recent comments on the significance of cultural effects, see the remarks of Secretary of the Treasury Robert Rubin, May 21, 1997.

[144]For an analysis of direct and indirect impacts, see Rhoades, 1979.

[145]See Baums and Gruson, 1993. In addition, the Western Allied Powers closed the *Reichsbank* and substituted a number of state central banks that were replaced by the *Bundesbank* in 1957.

relationships also reemerged as keiretsu family groups.[146] Revision to pre-war structures in Japan and Germany reflected, in part, changed attitudes among the Western powers.[147]

Important socio-political and cultural issues were neatly illustrated in a *Wall Street Journal* article on the German banking system in the late 1980s.[148] In reviewing the corporate governance event that revealed bank control of a large industrial concern, discussed above, the article quoted a member of the German Public Monopolies Commission as finding the source of bank power in "their huge but murky networks or equity holdings, external board seats and political contacts." The banks, the author notes, have often put their vast resources at the government's disposal to meet foreign policy aims and to bail out large industrial firms whose failure might create problems. The head of one of West Germany's few independent financial service firms remarked: "The one thing you have to say about our system is that a universal bank can give a company enormous support." But a maverick steel entrepreneur, whose company had collapsed for lack of credit, stated: "If one or two of the big banks turn against you, you're dead."

In explaining the support for universal banking in Germany, the president of the Federal Cartel Office pointed out that "West Germans are fanatics about security after the periods of economic misery

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[146]Scherer, 1990, p. 64.

[147]In the early 1980s, a study for the Joint Economic Committee observed: "The prewar period of bank consolidation [in Germany and Japan] is often associated with increasing controls and regulations, and is alleged to have formed the basis for control-dominated 'peculiarities' of the postwar Japanese financial system. . . .Of course, wartime controls were extensive; and the horrors of war speak for themselves. But this does not necessarily imply that the financial system that developed simultaneously is inherently fascist." See Sakakibara et al, 1982, p. 28.

[148]Roth, 1987.

in our history. Continuity with little risk is the bylaw of German bank customers, and the universal bank system offers that umbrella." He feared that West Germany was approaching industrial oligarchy: "There is no reason why banks should have any industrial holdings. . . . But if I were to summon up the courage to say we should do away with the universal banking system, most people would say I was crazy."

In summary, the article touched on the principal socio-political and cultural issues typically raised: (1) the dominance of large banking organizations over large commercial firms, (2) the murky sources of control, including political connections, (3) the symbiosis between large banks and the government, (4) the vulnerability of small business, (5) the appealing "security" of a social system characterized by large and powerful organizations, and (6) the resistance of the system to change.

Comparison with the United States suggests that these issues are not unique to universal banking. But there is a difference in degree. The prospect exists that the large banking-commerce conglomerates will have an increased influence on public policy by virtue of their size and importance. Any attempt to measure this influence quantitatively, however, is likely to be unsuccessful. Murky networks tend to frustrate objective measures. The nature and extent of such influence, therefore, is likely to be controversial. In a financial crisis, on the other hand, the conglomerates are likely to be targets for censure.

The existence of large banking conglomerates could indirectly assist an expansion of government intervention in the economy. An implicit constraint on government direction of resources in the United States has been the presumption that credit decisions are impartial and made at arms length. If this presumption is brought into question, through a perceived ownership bias, calls for government

intervention to level the playing field for independents are likely. Government may be forced into an expanded role in allocating financial resources. Aside from the issue of fairness, government may be lead to greater intervention in a deteriorating economy. Because banking-commerce conglomerates seem to provide a convenient way to direct resources, they could serve as a mechanism for industrial policy. Historically, this seems to have been the case in Germany and Japan.

The vulnerability of small and new business would depend on the effectiveness of competition in credit markets. The socio-political values of opportunity for small and new business are beyond quantification, but they emerged early in Anglo-American economic development and have in general been self-sustaining.

Perceptive analysis of the past half-century has found a close relationship between political democracy and a free market system. In the United States, markets have grown with little government interference and abundant opportunity for small and new business; the financial and economic system in the United States has also been compatible with political democracy. Though difficult to measure, the cultural differences between the United States and many other countries has been observable. System changes such as those posed by the integration of banking and commerce raise socio-political and cultural issues if for no other reason than because they create uncertainty about the permanence of markets as the principal allocator of resources, the implicit existence of wide-ranging opportunities for small and new businesses, and the distribution of political power.

4. DISCUSSION

The prospect of permitting the banks to combine with commercial firms raises a wide spectrum of issues.[149] A number are similar to those raised in the deliberations on bank entry into securities and insurance, but others, including possible reductions in transaction costs, a lower cost of capital for industry, effects on small business, corporate governance, inter-temporal risk smoothing, and the functioning of financial markets, are distinctive. So, in degree, are those related to competition, concentration, central banking, supervision, and the economic role of government. Lurking beneath these issues are socio-political questions that have only rarely been addressed in recent banking reform.

There have been a number of attempts to develop cost-benefit analyses based on some of the issues discussed above. Such analyses have, in general, been unpersuasive in a number of ways. First, the analysis must distinguish between benefits that can be realized only by eliminating the barriers between banking and commerce and those that can be realized in other ways. The potential beneficial effect of universal banking on the cost of credit and capital is likely to be more important than the potential impact on reduced risk through portfolio diversification because the advantages afforded by diversification are probably already within the reach of most large banks. Similarly, banks have increased capital without change.

Second, the quantitative significance of the likely effects in each area are not easily estimated. In some cases, good quantitative evidence may exist or could be developed, e.g., on transaction costs. In

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[149]The discussion that follows assumes changes permitting full ownership and control; that is, beyond making a more extensive portfolio of equity investments available to banks, and beyond passive “stake-out” investments of the Sumitomo-Goldman type.

other cases, such as economies of scope, quantitative evidence exists but not about the kind of activities universal banking would make possible. In still other cases, such as on many of the socio-political issues, no quantitative evidence is possible. The result is that the relative importance assigned to potential effects will reflect judgments that are bound to differ.

Third, many of the possible effects are related, so that one benefit or cost is likely to cause others. For example, if the cost of credit to affiliated commercial firms is reduced (asymmetric information/transaction costs), unaffiliated firms are likely to be at a competitive disadvantage. The numbers and importance of affiliated firms should increase and possibly form a concentration in the economy. There may also be some effect on the functioning of financial markets. True benefits and costs are likely to derive from a chain of effects.

Finally, even a reasonable judgmental analysis may not be persuasive because the significance of many of the effects are not easily weighted for comparison purposes. It is no simple matter to compare potential gains in economies of scale with the potential costs in reduced lending to small businesses. It is not possible to compare potential gains from economies of scope to the potential costs of one or more of the socio-political effects.

Although these difficulties should not be taken lightly, further analysis should prove fruitful. Careful comparisons with the German and perhaps the Japanese systems, focusing on supervision and central banking issues as well as socio-political questions, would be illuminating.

One final matter deserves mention. Universal banking developed in Germany and close bank-commercial firm relationships developed in Japan because of political decisions to accelerate industrialization. There is no critical need currently in the United States for eliminating the separation

between banking and commerce. Banking is not a declining industry; its profits have been exceptional and the cost of capital low. There is serious doubt whether commercial affiliations are needed for effective competition with foreign universal banks in the United States. And abroad, U.S. banks are generally permitted powers available to banks in host countries. Serious problems, however, have a way of developing quickly, and modest reforms have a way of developing into major changes. The issues raised above deserve careful consideration before emergencies occur.

5. CONCLUSIONS

The separation of banking and commercial firms in the United States is traceable to an English heritage that granted limited purpose corporate charters with monopoly privileges to private parties serving public functions. Chartered banks were to provide financial assistance to the governments that chartered them and to expand currency (bank notes) beyond the limits of gold and silver in a relatively safe way. In a developing free market economy, the nature of these grants dictated that their recipients not compete with other businesses. Safety seemed to require that they limit themselves to short-term credit. Longer-term credit would be available through other institutions and markets.

Banks in Germany and Japan developed differently. In the mid-nineteenth century, the governments of those nations enlisted banks in their policies of accelerated industrialization. They provided long-term capital and equity, as well as short-term credit. As providers of all credit needs, and owners of commercial firms as well as creditors, they established relationships with other businesses were much closer than like relationships in the United States.

The result has been two different types of banking and financial systems. In a global economy, it is understandable that comparisons should be made and that proposals for altering the restrictive system

in the United States be considered. A separation of banking from commerce is, after all, surprising in a free market system that permits private firms to engage in any lawful business and offers them substantial rewards to expand into new activities to meet changing market demands. It is only when separation is developed in its historical and institutional context that it makes any sense in the United States. In this context, however, proposals for change raise extraordinary economic, political, and cultural issues.

This paper has catalogued a wide range of issues that arise in considering the integration of banking and commerce in the United States. Currently, however, there is considerable uncertainty about these issues. Different evaluators are likely explicitly or implicitly to have different opinions of the importance of integration's potential effects and to project different relationships among them. Policy recommendations are likely to differ. One aim of this paper has been to provide a framework for informed judgment and further investigation

Separated banking, as it exists in the United States, and integrated banking, as it exists in other countries, each have their benefits and costs. Many of the costs and benefits are not quantifiable, and some that are quantifiable are incomparable. Despite the difficulties posed by standard cost-benefit analysis that incorporates all relevant issues, any comparative evaluation based on one or a few characteristics is likely to be overly simplistic. A careful review of all existing evidence, identification of gaps, and further investigation is needed.

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