BANKING, SECURITIES, AND COMMERCE: A EUROPEAN PERSPECTIVE

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Recent Developments

In a large number of countries, long-standing laws and customs separating commercial banking from securities activities are being removed or their effectiveness is being eroded by market pressures. Among the major industrialized countries, the United States and Japan are now virtually alone in retaining a formal segregation between commercial and investment banking. Elsewhere, Australia, Canada, New Zealand, and the United Kingdom have relaxed restrictions allowing banks to take equity stakes in stockbroking firms. France, Italy, Spain, the United Kingdom, and many other countries seem to be evolving toward universal banking, as traditionally practiced in Austria, Germany, the Netherlands, and Switzerland. The common ownership of banks, trust companies, insurance companies, and securities firms is becoming the norm.

Even in the United States and Japan, the legal barriers are less inhibiting than is often perceived. In their domestic operations, U.S. banks now have the capacity to underwrite 80 percent or more of domestic securities issues; in Japan, banks are able to circumvent some of the restrictions of Article 65 through interlocking share ownerships with securities firms. Both U.S. and Japanese bankers undertake investment banking in their overseas operations along universal banking lines.

The trend to universal banking in European markets is being reinforced by European Community (EC) directives, the goal of which is to create a single, unified market by removing barriers to the cross-border provision of financial services, to the establishment of

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branches or subsidiaries of EC financial institutions, and to transactions in securities on the various stock exchanges (Commission of the European Communities 1989). Among the permissible activities defined for banks are "investment activities"—identified as brokerage, market-making, and portfolio management—as well as trading for one's own account in transferable securities, money market instruments, financial futures and options, and exchange and interest rate instruments. Following universal banking lines, banks are also allowed to own stock in nonfinancial entities, limited to 60 percent of a bank's capital.

The "common passport principle" is a major means of implementing the single internal market program for 1992. The Second Banking Directive, with its technical supporting measures, establishes a single banking license that enables authorized banks to provide the whole range of permissible activities in all member states, regardless of local law, on the basis of home country control. A parallel Investment Services Directive provides a "common passport" for investment services firms (securities houses). Banks are thus able to undertake a broad range of securities activities, and they can gain access to securities markets and exchanges throughout the EC, either directly as banks or by acquiring or forming subsidiaries to undertake investment services (Key 1989).

Although many U.S.-based commentators would prefer to discuss the desirability of such links, this commentary focuses instead on three other questions:

1. What forces have prompted the merging of commercial banking and investment banking?
2. What consequences follow from the trend to universal banking for the structure of a single European securities market?
3. What are the implications of the trend to universal banking for the old question of the appropriate relationship between banking and commerce?

The Merging of Commercial and Investment Banking

Deregulation has clearly been an important proximate factor, with London's "Big Bang" followed by later financial reforms in France, Spain, and other Western European countries. But decisions to deregulate do not occur in a vacuum. A public interest type of explanation could point to a major revision in early postwar attitudes toward governmental controls across a number of countries and activities, which has led to privatization and structural deregulation in

a number of fields, including financial services. Competitive and technological developments have also eroded industry boundaries and reduced the effectiveness of inherited regulatory methods.

Deregulation is also responsive to pressures from firms in the regulated industries, and there may have been a parallel alteration in their attitudes toward governmental controls. In the aftermath of the 1930s, caution was probably uppermost in bankers' minds; and with competition subdued, regulation may have initially served their interests. Only later, as memories faded and with a new generation of bankers, would the benefits of enhanced competition be stressed.

On both public and private interest grounds, I agree with Ferrara (1990) about the importance of new technology in eroding barriers between countries and in broadening the range of financial services that can be provided profitably by the financial firm. In this context, "new technology" should include theoretical development in the theory of finance. In particular, Black and Scholes (1973)—who found that by continuously adjusting holdings of existing securities one is able to manufacture new ones—provide the intellectual basis not only of option pricing but also of "financial engineering" generally and the creation of "manufactured" or "synthetic" securities.

Pressures for change have also come from economic growth and financial sophistication, with more companies switching from informal banking markets for their financing needs to the organized securities markets. Borrowers can be thought of as forming two groups: first, governments and large corporations with an established financial record; second, those entities for which information cannot be communicated readily either because of high evaluation or monitoring costs or because the firms are unwilling to release information to the public. When a country is industrializing rapidly, a large number of its borrowers will fall into the latter group and be reliant on bank lending. As economic growth proceeds, more borrowers can be expected to move from the second to the first group, and financing evolves from the use of credit to the greater use of capital markets. Banks have both followed and led their customers to the securities markets, developing financial instruments that jointly meet their securities and banking needs.

Free competition, especially in the Euromarkets, has been a major part of the story. Securities markets are passing through a process of globalization, much as occurred in banking 20 years ago. Banking markets in different countries (and currencies) were then separated by controls and regulations. These differences created opportunities for banks in the Euromarkets, and the diversion of domestic business to them led eventually to pressures for domestic financial liberaliza-

tion, creating one international, short-term money market. Regulatory and informational barriers have also kept securities markets apart. These barriers have encouraged the growth of Eurobonds, and the decline of foreign bond issues has led to removal of many of the restrictions on domestic markets, paralleling what happened in banking. Nevertheless, this process is far from complete, and the new synthetic instruments effectively arbitrage the remaining regulatory and informational differences between markets.

Figure 1 shows how some of these elements fit together. Financing activities are classified into the origination of loans or securities, the distribution and warehousing of the loans or securities, and the provision of liquidity.[1] Traditionally in many financial systems these activities have been segmented into banking and securities markets, but the new instruments have increasingly blurred such distinctions. For instance, a multiple option facility (MOF) is a committed revolving credit line issued by a bank that enables a borrower either to obtain funds by a bank advance in a variety of currencies or to issue commericial paper or notes underwritten and distributed by the bank or a tender panel.

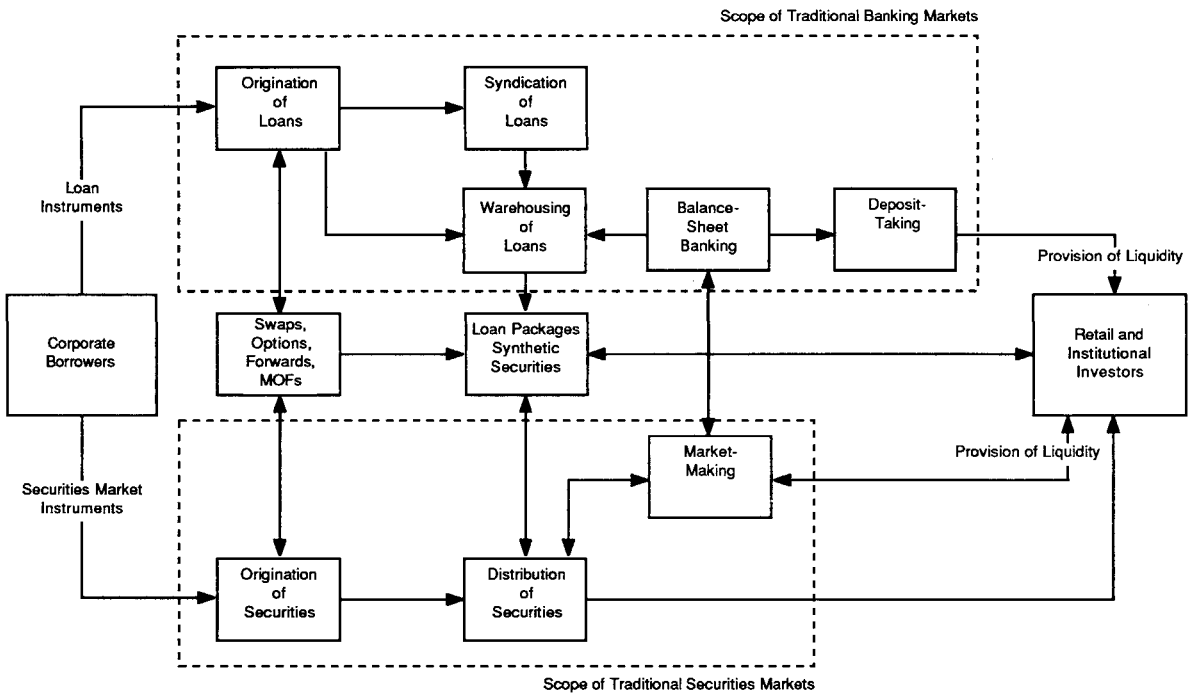
Another example is the creation of a synthetic security (see Lewis 1988). Combining an asset/liability with a hedging instrument (such as a financial futures contract or an interest rate or currency swap) creates a synthetic asset/liability with different interest rate, currency, or maturity characteristics. A large portion of issues of fixed rate bonds are "swap-driven"; that is, they form one leg of such a transaction. Because commercial banks play a major role in the swap market (swap positions outstanding at the end of 1989 are said to amount to $2 trillion), their entry to the international bond and securities markets has been easier.

Unless regulations prevent them, banks have diversified into one or more of the origination, distribution, or market-making in securities, especially in the Euromarkets. Any bank or securities firm from any country is free to compete in the Eurobond and Euro-equity markets, utilizing their perceived competitive advantages: Investment banks have good links with institutional investors, universal banks have associations with retail investors, and other banks can draw on established relations with corporate clients to meet the totality of the firms' financing needs (see Quinn 1989). This is not to say that all banking firms should undertake all types of securities business. Not all of the link-ups between commercial banks and

[1]For a discussion of the ways in which banking and securities markets provide liquidity, see Lewis (1990).

FIGURE 1

SECURITIES AND BANKING MARKETS



securities houses after the Big Bang have been successful: The established universal banks have generally performed better than the new ones put together by mergers and acquisitions. Nevertheless, the relative absence in the Euromarkets of legal restrictions on financing techniques has enabled banking firms to experiment with various combinations of financial activities and to settle on the one that works best for them.

The securitization process in banking markets has also made the similarity of some banking and securities market operations more apparent. Banking services have usually been fully integrated vertically within particular financial firms. Unbundling enables origination to be separated from the lending of funds or the warehousing of loans; it also enables other parties to insure the loans and still others to do the loan packaging, with different firms acting as trustees or collecting loan repayments. In functional terms, it is difficult to distinguish between underwriting and placing a debt issue on the one hand and originating a loan that is on-sold on the other. Many institutions syndicate loans and securities issued in the same department.

Those who argue for separation and insist on letting "bankers be bankers," "brokers be brokers," and "insurers be insurers" (Klein 1988) must accept that one market test in the Euromarkets offers little support for segregation. For many firms a universal banking model is the organizational form to which they have evolved.

A Single Bourse for Europe?

When banks become involved in securities markets, there are ramifications for the way in which European securities markets might be integrated. Presently, primary and secondary markets are highly fragmented, with nearly 40 different stock exchanges: some trading by open outcry, some by means of competing market-makers, some on screens, some with specialists, and some with auctioneers matching orders.

A market can be centralized formally around trading on the floor of a single exchange, which is typical of many continental bourses. In most cases, this involves relatively short auctioning sessions, although France, Spain, and Belgium have sought to transfer such order-based trading to screens by adaptation of CATS (developed in Toronto), whereby orders are matched by a computerized auctioneer. Alternatively, a market can be created by trading among the in-house dealers of banks and other institutions in an over-the-counter market. For the time being, competitive in-house market-making is the rule in London, with each market participant linked to the others by

telephone and screen displays. An over-the-counter market can also be intra-bank, which is the pattern in Germany and Italy where banks operate an internal marketplace by drawing on their own holdings of securities and matching buy-and-sell orders from among their own customers and business contacts.

Which is better? The simple answer is that each has its merits and drawbacks: Advantages are claimed for the auction system in terms of information and transparency and for dealer markets in terms of continuity and price stability. In auction markets, orders are transmitted to brokers or agents who represent transactors in a single-capacity basis, and buy-sell orders are matched on the trading floor. This allows adequate dissemination of information, equal treatment for all bids and offers, and open pricing by all participants. Off the floor, dealing is necessarily bilateral with pricing a result of one-to-one negotiations.

Both types of systems lend themselves to modern communications and can be said to be "transparent." The difference comes in the nature of the information transmitted. Dealer systems are quote driven: Market-makers display the latest bid-ask prices on SEAQ, but deals are struck on the phone. By contrast, agency-auction markets are order driven and have obvious merits if the aim is for market prices to quickly embody all current information about the demand and supply for securities. Also, because of the centralization of trading, agency-auction markets usually transmit information about completed transactions more quickly than markets based on diffused market-makers.

In dealer markets, prices are set by market-makers who buy up securities from the mass of sellers and on-sell them to the buyers, with a bid-offer spread. For transactors, the great boon of auction markets is that matching orders can be crossed directly without incurring the dealer's turn, while liquidity is achieved by having all buy-and-sell orders routed to one location and by limiting the duration of the auctioning process. The drawback is that continuity of pricing exists only for as long as the floor is open or while the stock is called. As Globex has demonstrated, dealer markets seem readily adaptable for 24-hour global trading with market-makers offering immediacy to large institutions in block trading.

There seems to be no good reason why the respective merits of auction and dealer systems cannot be subjected to the market test, allowing operators to transact in the market format that suits them best. Many markets, including the New York Stock Exchange (NYSE), already combine features of both. The NYSE is linked to other exchanges in the United States through the Intermarket

Trading System (ITS). This linkage ensures that orders are exposed to the appropriate market-makers in all the venues where the particular stock is traded, and it enables a broker to find the best prices.

Such price visibility provides a model for the Interbourse Data Information System (IDIS) that is planned for Europe, which would ensure that trades are made in the most advantageous venue in the EC. A significant difference would be that ITS uses a single currency—the dollar—while IDIS would have to cope with many currencies. Use of the ECU for pricing might remedy this, but inflation differentials and the periodic exchange rate adjustments they entail have an impact on the value of the ECU and reintroduce exchange rate risk.

Banking and Commerce

The trend to universal banking also leads to the question of the desirable relation between banks and industrial enterprises. One tradition is evident in the German-Japanese case of close bank-industry links, where banks acquire company stock and often sit on the board (Germany) or form part of linked groups (Japan). In the Anglo-Saxon tradition, there is an arm's length relationship reinforced by explicit legislation separating banking from commerce (as in the United States) or, at least until recently, by unwritten rules discouraging banks from commercial enterprise (in the United Kingdom).

Recent developments in banking theory offer an interesting perspective on these different approaches.[2] The theories argue the special informational role of banks when supplying credit for activities which, because of price-sensitive information or high evaluation, monitoring, and enforcement costs, cannot easily be funded by the issue of securities in the open market. By specializing in information production, banks save lenders the trouble and expense of gathering information themselves. A related service is that of monitoring the performance of borrowers without divulging publicly the information acquired.

For both of these services, close links between banks and industry would seem to allow a ready conduit for information to flow to the bank, better monitoring of a borrower's performance, less potential for opportunistic behavior, and risk-sharing within a group of affiliated companies. Such factors seem likely to account for the higher leveraging of German and Japanese companies relative to American

[2]The original contributions came from Leland and Pyle (1977), Campbell and Kracaw (1980), and Diamond (1984). Chant (1991) and Lewis (1991) provide recent surveys of the extensive literature that has developed.

and British firms, without raising bankruptcy rates (McCauley and Zimmer 1989).

Historically, links between banks and industry were not uncommon. Although textbooks frequently trace the evolution of modern banking to 17th-century London goldsmiths, there were many paths to banking and the earliest bankers were merchants. For a merchant, the granting of credit is a natural extension of trade dealings, and the firm seems likely to evolve into a bank by lending to enterprises with which it has established business relationships.

By contrast, the Anglo-Saxon model did not arise spontaneously. Separation of banking from commerce began when the Bank of England was chartered as a private banking corporation in 1694. It was not allowed to "deal or trade . . . in the buying and selling of any goods, wares or merchandise whatsoever" (Schull 1983, p. 260), and later acts granted it "monopoly privileges" over banking. These provisions were copied in the United States. The early U.S. banks were given monopoly rights over banking, and private individuals and firms were prevented from taking on banking functions once banks were chartered. Matters developed from there.

Such restrictions were and probably remain rooted in the public policy role created for banks. Originally, banks were regarded as a quasi-public utility involved in raising funds for lending to the federal or state government, establishing a sound currency, and providing financial assistance to local trade and commerce. Nowadays, banks are seen to have a special role as the creators of money, as custodians of the nation's liquid assets, and as the principal conduit for monetary policy. It is argued that they must not put other people's money at risk and must follow prudent rules about investments.

On this reasoning, the case for separating or for not separating banking from industry turns on whether close government-bank links are really needed in monetary affairs. If advocates of free banking can uphold the view that governments ought to be distanced from money and finance and that banks need be treated no differently from other private entities, then the case for special restrictions on banks' activities would lapse. Banks' links with other enterprises would then be left for market decisions to determine. Not surprisingly, there is a case for "free financing" that parallels the case for "free banking."

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