International Trends in the Combination of Banking, Securities, and Commerce

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The rapid pace of change in financial markets over the past two decades or so is often referred to as a financial market revolution. One of the major elements of this revolutionary change has been the blurring or outright elimination of the traditional and regulatory distinctions between banking and other financial or even nonfinancial businesses. This paper will examine current international trends in the combination of commercial banking with securities activities, investment banking, other financial activities such as insurance, and general commercial enterprises. The final section will discuss the reasons for these developments and whether the change is desirable.

Western Europe

The combination of banking with other businesses has gained the most momentum in Western Europe. In West Germany, Switzerland, Great Britain, France, Luxembourg, and the Netherlands, commercial banks can engage in securities underwriting and any investment banking activity, securities brokerage, insurance underwriting and brokerage, investment advice, currency trading, futures and options trading, and (except in Switzerland) any real estate development or sales activity.[1] According to the Institute of International Bankers (1988), banks in these countries can also own or be owned by commercial enterprises.

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[1]See, for example, Institute of International Bankers (1988); Levich (1985, pp. 280–82); Glassman (1988, pp. 15, 19–20); Cooper and Fraser (1984, pp. 76–83); Hamilton (1986, 130–54).

This "universal banking" model began in West Germany, where the links between banking and general commerce are the broadest. For example, the nation's largest bank, Deutsche Bank, owns 28 percent of German auto manufacturer Daimler Benz—the country's largest company by sales. With the assistance of Deutsche Bank, Daimler in turn recently expanded by acquiring Messerschmitt-Boelkow-Blohm G.m.b.H, a major aerospace and technology firm. Deutsche Bank also owns large shares of Phillip Holzmann AG, a construction group; Kloeckner-Humboldt-Deutz AG, a heavy equipment and engineering group; and Karstadt AG and Horten AG, two of the nation's largest retailers. Dresdner Bank, Germany's second largest bank, owns large shares of Metallgesellschaft AG, a manufacturer, and of Bilfinger Berger Bau AG, a major construction firm. The nation's number three bank, Commerzbank, owns a large share of Karstadt. These three leading German banks have each been involved in securities underwriting and brokerage for many years.

In Great Britain, where the now-American tradition of separating commercial and investment banking began, all the major British banks currently own investment banking operations and securities brokerage firms. Deregulation in both Great Britain and France in the 1980s expanded bank powers in those countries to match other major banking centers in Western Europe, leading to growing combinations of banking and securities activities in both countries. Italy allows its banks to conduct securities activities, investment banking, and other financial businesses, but prohibits cross-ownership between banking and commercial firms. (Institute of International Bankers 1988, pp. 35–40).

This overall pattern will be strengthened by the planned economic integration of the European Economic Community in 1992. By that year, EEC countries plan to establish a single, integrated, pan-European market in all goods and services, which will break down existing barriers among countries. As part of this broader effort, the EEC plans a common banking market in which each member country will be able to grant its banks a single EEC license authorizing the bank to operate in all other EEC countries. This license would empower the bank to engage in the full range of securities activities, including underwriting, dealing, and brokering debt and equity securities. As a result, all of Western Europe will become a unified major financial market combining commercial banking with the full range of securities and investment banking activities.[2]

[2]See Commission of the European Communities (1988a, 1988b); Gruson and Nikowitz (1989, p. 205); (Golembe Associates 1988, p. 1); Institute of International Bankers (1988, pp. 68–72); U.S. International Trade Commission (1988, pp. 5–1 to 5–30).

Even before the planned integration of 1992, European banks have begun to combine with insurance companies under existing powers. In West Germany, where the trend is called "Allfinanz," Deutsche Bank established its own life insurance company in 1989. The nation's largest insurer, Allianz, already owns two banks—Bayerisch Hypotheken Bank and Wustenrot Bank—and has established an extensive cross-marketing arrangement with Dresdner Bank. In 1989 Dresdner purchased a substantial stake in an Italian insurance firm, Norimberga Maecci Vita. Also in 1989, Commerzbank completed a deal to buy 50 percent of DBV and Partners, a national insurer. In 1987 Aachener und Munchener, Germany's fifth largest insurer, bought a controlling stake in Bank Fuër Gemeinwirtschaft.

In France, where the same trend is called "bancassurance," the country's largest bank, Banque Nationale de Paris, has recently exchanged 10 percent ownership shares with France's biggest insurer, Union des Assurance de Paris, with the two agreeing to an exclusive cross-marketing arrangement. The Groupe des Assurance Nationale, one of the largest French insurance organizations, recently acquired Compagnie de Credit Industriel et Commercial, a leading French bank. In late 1989 Compagnie Financiare de Suez, a leading French investment bank that owns Banque Indosuez and other commercial banking interests, acquired Victoire-Colonia, the largest private insurance company in France and the second largest in Germany. It subsequently purchased a large stake in Baltica Holding, Denmark's largest insurance company. Credit Lyonnais, another leading French bank, sells insurance directly, including fire, accident, health, and other types of coverage. Another French bank, Credit Foncier, has recently established its own life insurance branch. Still another major French bank, Credit Agricole, runs a life insurance company jointly with Groupama, an insurance mutual firm.

In Great Britain, one of the nation's major clearing banks, Lloyd's, recently purchased Abbey Life, a major insurer. A major Italian bank, Instituto Bancario San Paolo di Turin, recently acquired three Italian insurance companies in a joint venture with British insurer Royal Guardian Exchange. Banco Nazionale del Lavorro and Carra di Risparmio delle Provincie Lombardi are other Italian banks that have recently acquired insurance companies. In Holland, the third largest insurer, Amer Group, has exchanged major shareholdings with Verenigde Spaarbank, Holland's top savings bank. In 1988, Spain's Banco Atlantico sold a stake to insurer Assurances Generales de France. In the same year, Banco Popular Español entered a joint venture with insurers Allianz of Germany and RAS of Italy to sell life insurance

in Spain. Belgian Generale Bank and Union Bank of Finland also have recently purchased insurance companies.

If this trend continues, by 1992 Western Europe will present a unified banking market broadly combining commercial banking, investment banking, securities activities, and insurance. Indeed, the EEC initiative is likely to lead all nations of Western Europe to adopt the broad universal banking powers of the major countries described above. The simple pressure of competing in an otherwise highly integrated economic market with the existing universal banking systems of the major EEC powers is likely to lead the others to liberalize their systems so they can maintain their competitiveness.

The one countertrend is that in West Germany the broad ownership links between the nation's top banks and top commercial industrial firms are under political attack, with a number of proposals pending before the government to cut back on such links. But whether such new policies will be adopted is uncertain. Given long-standing West German traditions, ownership links between banking and commerce are unlikely to be banned altogether.

The Far East

The financial industry of Japan presents a curious mixture of Japanese economic traditions and American notions of financial regulation imposed during the American occupation after World War II. In practice, Japanese banks are heavily intertwined with major commercial firms in collaborative groupings of Japanese companies that work closely together, which is a central, traditional feature of the nation's economy. The banks each own stock in the commercial companies of their respective collaborative groups, and the commercial companies own stock in their group's bank. Japanese banks, therefore, are not separated from commerce.[3]

Formally, Japanese commercial banks are supposed to be separated from other major financial service institutions, particularly securities firms and investment banks, analogous to the American regulatory system. Yet, the collaborative groupings of Japanese companies include investment banks, securities firms, and insurance companies, along with commercial banks. The Mitsubishi Group, for example, includes Mitsubishi Bank, three insurance companies, and five securities firms. The Japanese government is also favorably considering proposals to abolish the American-style restrictions that

[3]See Institute of International Bankers (1988, pp. 41–49); Hamilton (1986, pp. 164–65, 173–74, 177–78); Levich (1985, pp. 280–82); Glassman (1988, p. 20); Cooper and Fraser (1984, pp. 89–90).

seek to separate banking from other financial institutions, and most observers believe it will do so in the near future to enhance the international competitiveness of the country's banks. (*Euromoney* 1989, p. 5).

Hong Kong and Singapore are other major banking markets in the Far East where the banks already have the same broad range of powers as in the leading Western European financial centers discussed above. (Institute of International Bankers 1988, pp. 29–34; Cooper and Fraser 1984, pp. 76–83).

North America

Canada has recently begun phasing in a deregulatory plan that will eliminate separations between its commercial banks and other financial institutions. Historically, Canada has had regulatory restrictions separating its financial services into four categories: (1) commercial banks; (2) investment banks and securities brokerage firms; (3) insurance companies; and (4) trust and loan companies that manage funds, perform fiduciary activities, and provide real estate financing. Under the new deregulation plan, however, a firm in any of the four categories will be able to establish subsidiaries to engage in activities of each of the other categories. Firms in any or all of the four categories could be jointly owned by a holding company as well. Trust and loan companies will also be able to own companies engaged in real estate management, development, and brokerage. The plan, however, will retain the current separation between banking and general commerce (Institute of International Bankers 1988, pp. 41–49).

The United States still maintains the Glass-Steagall Act, which seeks to separate commercial banking from securities and investment banking activities, and the Bank Holding Company Act, which seeks to separate commercial banking from other financial businesses and general commerce. Indeed, the most recent legislative change in the United States sought to strengthen these policies. The Competitive Equality Banking Act of 1987 eliminated the opportunity for nonbank financial firms and commercial firms to establish so-called "nonbank banks," which could provide deposit services without commercial lending. That act also further restricted U.S. banks from offering insurance services.

However, U.S. regulatory authorities have administratively relaxed the Glass-Steagall restrictions to an extent in recent years. Banks now can underwrite municipal revenue bonds, mortgage-backed securities, consumer-debt-backed securities, corporate debt,

and, most recently, even corporate equities through bank holding company subsidiaries that are not "principally engaged" in such activities, which means that no more than 5 percent of the subsidiary's revenues may be derived from them.[4] In addition, banks can now privately place commercial paper[5] and can provide discount securities brokerage services.[6] More recently, the regulators have begun to allow banks to provide investment advice along with this discount brokerage.[7]

Other exemptions have been longstanding. U.S. banks can underwrite and deal in federal, state, or local general obligation bonds, which are to be paid out of general tax revenues (12 U.S.C. §24 [1989]). American banks overseas can also underwrite corporate bonds, as well as up to $2 million in equities per issue.[8] State chartered banks that are not members of the Federal Reserve System are exempt from the Glass-Steagall Act altogether (House of Representatives 1987, pp. 5–6; Isaac and Fein 1988, p. 331). Moreover, nonbank financial or commercial firms may own thrift institutions and individuals may own both banks and nonbank firms (Huertas 1988, pp. 289–91). Nevertheless, the general policy of separating commercial banking from securities and other financial activities, and from general commerce, remains in place.

Even the United States, however, is likely to repeal much if not most of this overall policy in the near future. All the major federal

[4]Citicorp, 73 *Fed. Res. Bull.* 473 (1987); Chase Manhattan Corp., 73 *Fed. Res. Bull.* 367 (1987); Chemical N.Y. Corp., 73 *Fed. Res. Bull.* 731 (1987); Securities Indus. Assn. v. Board of Governors of the Fed. Reserve Sys., 839 F. 2d 43 (2d. Cir. 1988), Cert. den., 56 U.S.L.W. 3849 (1988); Securities Indus. Assn. v. Fed. Reserve Board, *Fed. Banking L. Rep.* (CCH) § 87, 368 (D.C. Cir. 1988); House of Representatives (1987, p. 7); Isaac and Fein (1988, pp. 281, 330–31).

[5]Securities Indus. Assn. v. Board of Governors of the Federal Reserve System, 807 F. 2d 1052 (D.C. Cir. 1986), cert. den., 107 S. Ct. 3228 (1987); House of Representatives (1987, pp. 6–7); Isaac and Fein (1988, pp. 331–32).

[6]12 C.F.R. § 225.4 (15) (1989); Security Pacific National Bank, *Fed. Banking L. Rep.* (CCH) § 99,284; Security Indus. Assn. v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207 (1984); House of Representatives (1987, pp. 6–7); Isaac and Fein (1988, p. 326).

[7]American Nat'l. Bank of Austin, Texas, *Fed. Banking L. Rep.* § 99, 732 (1983); National Westminster Bank, PLC, 72 *Fed. Res. Bull.* 584 (1986); J. P. Morgan and Co. Inc., 73 *Fed. Res. Bull.* 810 (1987); The Royal Bank of Canada, 74 *Fed. Res. Bull.* 334 (1988); Sovran Financial Corp., 73 *Fed. Res. Bull.* 744 (1987); The Bank of Montreal, 74 *Fed. Res. Bull.* 510 (1988); OCC Interpretive Letter No. 386, *Fed. Banking L. Rep.* (CCH) § 85,610; OCC Interpretive Letter No. 403, *Fed. Banking L. Rep.* (CCH) § 85,627; Securities Indus. Assn. v. Board of Governors of the Fed. Reserve Sys. (D.C. Cir. 1987), cert. den., 108 S. Ct. 697 (1988); Isaac and Fein (1988, p. 298).

[8]See General Accounting Office (1988b); House of Representatives (1987, p. 5); Isaac and Fein (1988, pp. 343–45).

bank regulators now support allowing U.S. banks to affiliate with other financial and even commercial enterprises, except the Federal Reserve, which supports retaining the separation between banking and commerce (FDIC 1987; House of Representatives 1987, pp. 100–324; Corrigan 1987). While Congress has been highly responsive in the past to special interest pleas for protection from bank competition, the legislators know that the separation between banking and securities at least is grossly outdated and out of step with the rest of the world and must be changed. Moveover, the Securities Industry Association has recently voted to drop its opposition to repeal of Glass-Steagall, so the main special interest force against reform on this issue has been removed.

On the other hand, the thrift insurance crisis has created an adverse political environment for considering deregulation and new powers for banks at the moment. But this concern is likely to be overcome. Congress will ultimately become concerned about the need to keep U.S. banks and banking markets competitive with the rest of the world. Moreover, repeal of the restrictions will actually improve the safety and soundness of banks by better enabling them to meet the competition, diversify their risks, and gain advantages of economies of scope (Ferrara 1989). Reform proposals to allow the new activities only in separately incorporated affiliates, which are insulated from the bank, avoid deposit insurance problems (FDIC 1987). If one considers the American legislative cycle and growing publicity surrounding changes in Europe, major legislation on this issue will probably be enacted in 1992. Glass-Steagall will probably be repealed, and the debate will focus on whether to allow bank affiliates to engage in insurance, real estate brokerage, and general commerce.

The hidden story of the U.S. system, however, is that banking is already combined with securities, other financial activities, and even general commerce, all of which are outside the formal banking system. Corporate borrowers increasingly raise funds by issuing securities directly to the marketplace, rather than by borrowing from banks. Nonbank firms also increasingly provide commercial loans and other forms of lending, such as mortgages, car loans, consumer credit, credit card debt, and others, by issuing securities to raise the funds, by pooling the loans, and by selling securities representing shares in the pool. As a result of this process of "securitization," securities are now heavily involved in performing the traditional credit functions of banks. Securities activities such as underwriting and dealing are now part and parcel of the traditional credit functions that banks have always served. Moreover, through these securities activities

any nonbank firm can now perform the traditional credit functions of banks as well as or better than banks, and can mix these banking functions with nonbank financial or even commercial enterprises.[9]

Indeed, there has never been any legal restriction in the United States on the authority of nonbank firms to provide any sort of loan or credit, commercial or otherwise, and nonbank firms are taking advantage of this power. Major manufacturers who began in financial services by extending credit to their corporate purchasers now often expand to provide commercial loans to noncustomers in direct competition with banks. For example, General Electric Credit Corp. (GECC) is now a major commercial and industrial lender, with 300 offices offering such loans across the country.[10] GECC provides only 5 percent of its credit for the purchase of General Electric products. Rosenbaum and Seigel identified 32 large nonbank companies in the United States in 1983 that together had one-third the volume of commercial and industrial loans as the 15 largest bank-holding companies. These nonbank companies also had a higher volume of lease financing than all U.S. commercial banks combined (Rosenbaum and Siegel 1983).

On the consumer credit side, General Motors Acceptance Corp. and Ford Motor Credit Corp. are both larger than GECC and provide a broad range of consumer financing as well as auto loans.[11] Nonbank firms now provide as much auto financing as banks (FDIC 1987, pp. 7–9). Rosenbaum and Siegel found that in 1983 only 2 of the 5 largest consumer lenders, and only 6 of the top 15, were banks. Overall, of the 27 largest lenders for all types of credit, 15 were bank-holding companies and 12 were nonbank conglomerates (Rosenbaum and Siegel 1983).

The only bank service, in fact, that is legally restricted to banks in the United States is deposit taking. But nonbank firms today can offer the functional equivalent of bank deposits, including checking accounts. The most significant deposit equivalent is the money market fund, which is now regularly offered with unlimited access by check and automated teller machine.[12] Nonbank firms can even

[9]For further discussion, see Ferrara (1989, pp. 16–23).

[10]See Gart (1985, pp. 22–24); Litan (1987, pp. 44, 115); Rose (1988, p. 331); England (1988, p. 257); Hamilton (1986, p. 107).

[11]Litan (1987, pp. 46, 79, 115); Rose (1988, p. 331); England (1988, p. 257); Hamilton (1986, p. 98).

[12]See Cooper and Fraser (1984, pp. 5–7); Pierce (1988, p. 30); Karmel (1988, p. 52); "An Alternative to Throwing Stones" (1986, pp. 281, 297); Bryan (1988, p. 15); Bentson (1986, p. 12); OTA (1987, pp. 9, 12, 63, 72, 90, 98, 100, 107, 174, 195, 197, 233); Burns (1988, p. 15); House of Representatives (1987, pp. 66–67); Langevoort (1985, pp. 747, 749).

obtain government guarantees for these funds by investing them in government-backed investments. These firms can also broker funds into governmentally insured bank deposits and retrieve them to pay off checks written on the firm's money market accounts.[13] Any nonbank firm can also own a single thrift, through which deposit services can be provided (12 U.S.C. §1730a[1989]). Since any nonbank firm can offer these deposit equivalents along with any form of lending and any other nonbank service, all bank functions can be and are provided *outside the banking system* in the United States, in combination with any securities activity, nonbank financial service, or commercial enterprise.

Taking advantage of these opportunities, financial supermarkets have arisen to offer virtually every financial service under one roof, often with general commercial activities as well. Sears (1989), for example, offers the following services: auto, life, property, casualty, and homeowner's insurance through its Allstate Insurance affiliate; retail securities brokerage, money market funds, mutual funds, and annuities through its Dean Witter affiliate; real estate brokerage, mortgages, and title escrow services through its Coldwell Banker affiliate; a national credit card with 26 million cardholders through its Discover Card enterprise; and deposit services, consumer loans, and mortgages through a thrift subsidiary and a grandfathered nonbank bank (Gart 1985, pp. 56–60). Sears (1989) also engages in investment banking, asset management, and real estate development activities, besides maintaining the nation's leading retail department store chain and consumer catalog service (Gart 1985, pp. 56–60).

Similar financial supermarkets include Merrill Lynch (1989), American Express (1989), Prudential Bache, and J. C. Penney.[14] A large number of companies also combine at least some traditional banking services with some nonbanking financial or commercial services, without trying to cover every financial activity as the supermarkets attempt to do (Ferrara 1989, pp. 34–37).

These phenomena are not unique to the U.S. system. But what does seem peculiar to the United States is the curious attempt to maintain regulatory separations among banking and other financial and commercial activities while these same activities are combined with all activities of commercial banking outside the formal banking system. The result is simply to disable formal U.S. banks from fully competing and participating in the modern financial marketplace,

[13]For a further discussion, see Ferrara (1989, pp. 25–27).

[14]Gart (1985, pp. 12, 56–64, 76–77, 78–79); England (1988, p. 257); Hamilton (1986, 107).

which is probably the most compelling reason for reform of the U.S. system.

Evaluation of the Trend

Why this worldwide trend to combine what was formerly separate by law and tradition? The regulatory barriers are falling because, as discussed above in regard to the United States, banking can no longer be practically separated from other activities. Securities are now heavily intertwined with every aspect of traditional bank credit. Nonbank firms, whether financial or commercial, can currently offer the equivalent of bank deposits along with any loan. In this environment, attempts to artificially separate formal banks from other activities will just arbitrarily disable formal banking institutions from meeting the competition in the modern marketplace. Countries around the world are removing these artificial regulatory separations because they want their banks and banking markets to remain competitive.

Why is the market moving to such combinations? Modern communications and computer technology have made performing the credit functions through securitization easier, cheaper, and apparently more efficient in many if not most circumstances than traditional bank credit.[15] Issuers of various securities can more broadly, rapidly, and cheaply communicate and transact with widely dispersed investors in a nationwide and even global market. Buyers can collect relevant information about securities offerings more quickly, easily, and cheaply, and can better analyze and monitor the information and risks involved. Consequently, buyers in the open market can better evaluate the creditworthiness of corporate security issuers or of the credit instruments in a securitized pool. Storing and referring to information is also much easier and cheaper, and can be done more rapidly. Thus both sellers and buyers can effectively and efficiently keep track of and carry out their responsibilities in a complex securitized arrangement. Cost is reduced for the whole range of transactions involved in pooling debts, issuing shares in the pool, collecting payments on the underlying debts, transmitting payments to security holders, and pursuing collection and foreclosure procedures. These factors have led the market to turn to securities more and more to perform the traditional bank credit functions, thereby producing the combination of this banking activity and securities. Indeed, in the

[15]Ely (1988, pp. 4–5); OTA (1987, pp. 65, 66, 67, 75–76, 80–82, 84, 94, 210–11, 214–215, 225); Haraf and Kushmeider (1988, p. 3); Bryan (1988); Isaac and Fein (1988, pp. 292–93).

modern marketplace, securities and their associated activities of underwriting and dealing are now essential components of major lending institutions.

The new technology has also made possible the development of deposit equivalents such as money market funds on a cost-efficient basis.[16] These funds are invested in numerous highly liquid short-term securities that mature and turn over rapidly. The new technology made holding large portfolios of such securities feasible and cost-effective, because firms could more easily and cheaply collect and analyze information about available securities, carry out the purchases, and administer the securities and their payment flows in portfolio. The technology also allowed firms to perform the following tasks more quickly, easily, and cheaply: communicate with customers and their payers and payees, collect and store information about their accounts, and transfer funds into and out of their accounts. These developments allowed firms to keep track of and administer numerous small accounts more cost-effectively. But more importantly, these were the crucial factors that enabled firms to provide their customers full, unlimited checking authority to gain access to their accounts. The new technology also enabled firms to provide automated teller machines that allow customers immediate, 24-hour access to their accounts.

Once technology made such deposit equivalents economically feasible, nonbank firms found offering them attractive to their customers. Consequently, banks' deposit as well as lending services became combined with nonbank financial or even commercial firms.

New technology has also promoted the entry of nonbank firms into traditional banking activities by creating new economies of scope and scale, which make banking activities attractive complements for existing activities of nonbank firms.[17] The information developed to provide one financial service to a customer is often helpful in providing other financial services. Modern communications and computer technology make it easier, cheaper, and more efficient to use that information to provide these other financial services. The information can be more cheaply collected, stored, and monitored, and it can be communicated from one market to another. Providing the consumer with a broad array of choices that are based on a basic set

[16]OTA (1987, pp. 90, 109, 191, 193, 202, 212); Gart (1985, p. 48); Hamilton (1986, p. 38); Burns (1988, p. 23); Kaufman et al. (1983, pp. 103–4); Cooper and Fraser (1984, p. 193); Edwards (1986, p. 17).

[17]OTA (1987, pp. 63–64); Edwards (1988, p. 114); Haraf and Kushmeider (1988, p. 26); Kaufman et al. (1983, pp. 103–4); Litan (1987, pp. 17, 76–78); Bentson et al. (1986, pp. 139–40); Mussa (1986, pp. 123–25); Saunders (1988, p. 18).

of data about that consumer has become more feasible and cost-effective as well. Moreover, technology provides some firms with the ability to provide services that have always seemed otherwise complementary to their activities. Technological factors leading to the securitization trend, for example, enable a real estate brokerage firm to obtain the funds to provide mortgages to its homebuying customers.

The 1920s exhibited some of the same combinations of banking and other activities that we have discussed, particularly the entry of commercial banking into investment banking (Merris and Wood 1985). But those combinations did not occur to the same extent as today, and the impact of securitization in the credit markets was not nearly as great. While investment banks were involved in deposit taking, the activity was not nearly as extensive or as broad-based as money market funds and other deposit equivalents offered today by firms outside traditional depository institutions. Nor did we see evidence of the extensive combination of banking with insurance and general commerce that we see today. On the other hand, in countries such as Germany, which have longstanding laws and traditions favoring combinations of banking and other activities, many combinations date back even further than the 1920s. Such combinations reflect the fundamental, close economic, and functional relationship among traditional banking and many other activities, such as securities underwriting.

But is the trend toward combining banking with other financial and commercial activities desirable? New combinations increase competition in financial services and elsewhere. Bank organizations are entering and providing greater competition in investment banking, securities brokerage, insurance, real estate brokerage and development, and other businesses. Conversely, investment banks, securities brokers, insurance companies, and commercial enterprises are entering and providing greater competition in banking. This increased competition should reduce prices and improve services in financial markets. Consumers will also benefit from the convenient combinations of different services, which allow them to enjoy the benefits of economies of scope in consumption of such services.

The trend is also improving bank safety and soundness in several ways. Bank organizations are reducing their risk by diversifying into different financial and commercial businesses, improving the distribution of their returns, and possibly increasing the overall level of their returns as well.[18] Banks are also gaining the efficiencies of

[18]FDIC (1987, pp. 2, 60–62); Litan (1987, pp. 81–98); Bentson (1986, pp. 25–26, 139–40, 164, 170–71); House of Representatives (1987, pp. 33, 35, 37–38).

economies of scope in providing complementary services. Through these new combinations, banks are also better able to compete in the modern marketplace, and to provide the full range and combinations of services that modern markets demand.

The chief concern over the new trend is that new activities pose substantially greater risks for banks than traditional banking activities. Also new combinations may undermine bank safety and soundness. In my view, these concerns are misplaced. Risk cannot be controlled by restricting banks to certain categories of activities, because banks can take on any level of risk within any single activity. Banks providing mortgages could lend on geographically concentrated, speculative properties, at fixed rates, to buyers who have bad credit histories and small incomes relative to debt burden and who put little or no money down. Banks providing consumer credit could grant high-limit credit cards to customers who have modest incomes and weak credit ratings and who cannot get credit anywhere else. As Bentson suggests, banks are surely capable of attaining the level of risk each prefers within their current range of activities, and therefore new activities should not cause them to operate at higher risk (Bentson 1989, pp. 161–63, 175–76).

Moreover, the impact of a new activity on a bank's risk cannot be assessed by examining the risk of the new activity alone. Modern portfolio analysis shows that the impact depends on how the new activity relates to the portfolio of an organization's current activities (Ferrara 1989). Even if the new activity has greater income variance than current activities, the organization's overall risk would actually be reduced if the income variance of the new activity was negatively correlated with the variance of the current activities. Income from the new activity would then tend to be up when income from the current activities was down and vice versa, thus reducing income variance for the entire organization. Indeed, new activities with more variable income than current activities could reduce overall variance even when their income is positively correlated with the old activities, as long as the correlation of the returns is less than the ratio of their standard deviations (FDIC 1987, p. 61). The income of the new activities might then vary little when the income of the old activities was varying the most and vice versa, again leaving the entire organization with less income variance. New activities with more variable income positively correlated with the income variance of current activities could also reduce the organization's overall risk if the more variable profits of the new activities were sufficiently higher than the profits of the old activities. The whole organization would then be sufficiently profitable to avoid any increased risk of failure despite

the greater variance in overall income. New activities could also reduce risk by enabling an organization with complementary activities to gain the efficiencies of economies of scope, thereby reducing costs.

There is also no reason to believe that new activities would necessarily be more risky than current bank activities. If we examine the risks of the most controversial new activity for banks, securities underwriting, we find that it is not significantly different from the risks of long-established bank activities (Ferrara 1989, pp. 93–102). The default risk borne by an underwriter holding a security issue for a few hours or days at most is trivial compared to the default risk borne by banks in traditional lending. While underwriters face the risk of a change in value during the brief period they hold a new security issue, banks that hold corporate bonds as investments face the same risk for the entire term of the bond. Banks also face a similar risk with traditional bank loans for the entire period of the loan, because a change in interest rates, for example, could cut into the return on the loan. Banks face similar risks when dealing and holding inventories in foreign exchange or in futures and options on currencies, market indexes, and other items.

While an underwriter faces the risk of getting a sound offering price for each issue, banks face a closely analogous risk in setting the interest rates for their loans and the prices for currency futures and options, where they act as specialists or market makers in these instruments. Moreover, this is not a pure market risk, but a matter of the underwriter's competency and capability. There is no reason why bank organizations cannot perform this function as well as anyone else. Studies show that underwriters have been able to reduce this risk to quite manageable levels (Giddy 1985; J. P. Morgan & Co. 1984, pp. 12–15).

Possible problems caused by the perverse incentives of deposit insurance in some countries can be avoided by allowing new activities in separately incorporated, insulated affiliates.[19] Moreover, we should ask: Why should allowing any new activities under the incentives of deposit insurance be any more of a problem than allowing the current activities? Banks can certainly get into a great deal of trouble with any traditional market activity, as discussed above. Bent-

[19]Despite the comments of O'Driscoll (1988), this argument has been thoroughly hashed out in the literature. See, for example, Ferrara (1989, pp. 98–106); FDIC (1987); Fischel et al. (1987, pp. 301, 333); House of Representatives (1987, 36–38, 45–53, 78–81); Bentson et al. (1986, pp. 150–52); GAO (1988, pp. 17–18, 54–63); J. P. Morgan (1984, pp. 18–19); Litan (1987, pp. 135–36, 145–50, 162–63); Pierce (1985, pp. 27–28); Pierce (1988); Huertas (1984, pp. 148, 156).

son (1989, pp. 175–76) argues that since banks can attain their desired level of risk under the incentives of deposit insurance through their traditional activities, new activities should not increase risk. Overall, the effect of the trend toward combining banking with new activities should be to reduce rather than increase risk, for the reasons discussed above (compare O'Driscoll 1988). The experience around the world to date does not seem to suggest any threat of increased risk.

Another key concern raised over this trend is that it will increase economic concentration and thereby have negative competitive effects. But this argument is only another manifestation of the old antitrust paradox—restricting competition in the name of preserving it. The trend clearly involves an increase in competition as banks are entering and providing new competition in financial or nonfinancial fields, and nonbank firms in these fields are entering and providing greater competition in banking. Indeed, since the trend involves new interindustry penetration, the trend will clearly not increase concentration in any affected market. It will unambiguously reduce concentration in all affected markets through the new competition.

Conclusion

In major financial markets around the world, commercial banking is increasingly combined with securities, investment banking, insurance, and other financial or nonfinancial activities. Regulatory barriers against such combinations are coming down. This trend reflects modern market realities and new technological developments that have made such combinations feasible and more attractive.

New combinations are increasing competition in financial services and elsewhere, and they benefit consumers through the convenience of economies of scope in the joint consumption of financial services. Moreover, contrary to the usual fears, the trend is improving the safety and soundness of banking organizations.

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