The Future of Universal Banking

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Universal banks have long played a leading role in Germany, Switzerland, and other Continental European countries. The principal financial institutions in these countries typically are universal banks offering the entire array of banking services. Continental European banks are engaged in deposit taking, real estate and other forms of lending, foreign exchange trading, as well as underwriting, securities trading, and portfolio management. In the Anglo-Saxon countries and in Japan, by contrast, commercial and investment banking tend to be separated. In recent years, though, most of these countries have lowered the barriers between commercial and investment banking, but they have refrained from adopting the Continental European system of universal banking. In the United States, in particular, the resistance to softening the separation of banking activities, as enshrined in the Glass-Steagall Act, continues to be stiff.

The purpose of this paper is to analyze the German and Swiss experience with regard to universal banking. We attempt to show to what extent that experience supports or refutes the arguments against universal banking frequently voiced in the Anglo-Saxon world. Since we are most familiar with the Swiss banking system, we rely heavily on our own experience. Based on this analysis, we draw various conclusions about the future of universal banking.

The remainder of the paper is divided into four parts. First, we discuss the salient characteristics of the German and Swiss banking systems, and attempt to rectify various misconceptions about universal banking. Second, we contrast the history of German and Swiss banking legislation with that of the United States. Third, we consider the

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arguments in favor of and against universal banking. Finally, we end with a concluding section on the future of universal banking.

Salient Characteristics of the German and Swiss Banking Systems[1]

Popular discussions of universal banking are often flawed by misconceptions about the characteristics of Continental European financial systems. The German system, in particular, is frequently portrayed as being dominated by large oligopolistic universal banks with branches all over the country. German banks are said to intermediate the bulk of financial flows, while domestic capital markets remain underdeveloped. Furthermore, emphasis is placed on the fact that German banks tend to hold equity stakes in industrial companies and, therefore, wield considerable influence on their management.

This characterization of the German banking system is overly simplistic and fails to do justice to the realities of universal banking. It is certainly true that in countries like Germany and Switzerland large universal banks with nationwide networks of branches play an important, if not dominant, role. However, this simplistic description omits crucial features of universal banking that tend to get lost in the public debate. Three such features are worthy of note:

- Even if legislation allows for universal banks, not all financial institutions choose to offer the entire gamut of banking services. Only the largest institutions tend to be truly universal banks, which coexist with smaller, specialized institutions. Moreover, universal banking may take on a variety of institutional forms.
- The importance of universal banks has tended to increase since the end of World War II. But the techniques employed for promoting universal banking have varied. In particular, there are substantial differences between Switzerland and Germany in this regard.
- Universal banking need not prevent capital markets from playing an important supplementary role in financial intermediation. The German and Swiss experiences also differ significantly in this respect.

Universal Banking and Specialization

Table 1 provides information on the structure of the German and Swiss banking systems. In both countries, financial institutions may

[1]See Francke and Hudson (1984), and Pozdena and Alexander (1992) for descriptions of the German financial system. A similar description for Switzerland is provided by Birchler and Rich (1992).

TABLE 1

BANKING STRUCTURE IN GERMANY AND SWITZERLAND, 1991

	Number of Banks (End of Year)	Percentage Share of Banking Group in Total Assets (End of Year)	Commissions as a Percentage of Net Revenue
Germany			
Big Banks	4	9	26
Regional Banks	198	14	21
Government-owned Savings Banks	757	34	14
Savings Banks	746	20	14
Central Savings Banks	11	14	12
Cooperative Banks	3,158	15	16
Credit Cooperatives	3,154	11	14
Central Cooperative Banks	4	4	30
Private Banks	84	1	29
Branches of Foreign Banks	60	1	29
Other Financial Institutions	102	25	n.a.
Total	4,363	100	18
Switzerland			
Big Banks	4	49	47
Regional & Savings Banks	189	8	19
Cantonal Banks	28	20	21
Cooperative Banks	2	3	9
Private Banks	19	1	80
Branches of Foreign Banks	16	1	34
Other Banks	222	16	54
Finance Companies	112	2	32
Total	592	100	44

SOURCES: Deutsche Bundesbank (1992a: Tables 13, 22a; 1992b: 42–47), and Swiss National Bank (1992: Tables III, 1.1; 40.0–40.8).

be classified into broadly similar groups: big banks, government-owned savings banks, regional banks, cooperative banks, branches of foreign banks, and private banks. In addition, both countries feature one or two remaining groups of diverse and highly specialized institutions.

The group of big banks comprises institutions with nationwide branch networks, as well as an important international business. They are truly universal institutions involved in all aspects of banking. They play a leading role in financing foreign trade and industry. They are also heavily engaged in investment and trust banking. Most of the big German and Swiss banks occupy an important position in domestic and international securities markets. They act as leading underwriters of domestic and international securities issues. The big Swiss banks, in particular, are also well known for their role as international portfolio managers.

The regional banks, as their name indicates, normally confine their activities to specific regions. In Germany that group includes the subsidiaries of foreign banks. Regional banks tend to be more specialized than the big institutions. The largest German regional banks, however, have turned into truly universal institutions. They have spread to other parts of the country and have also penetrated foreign markets. They now operate nationwide branch networks, but remain "regional" in the sense that they continue to focus their business on their home region. Many of the large German regional banks are also authorized to engage in mortgage lending. In Switzerland most of the regional banks, in fact, are small savings banks heavily engaged in mortgage lending.[2] These banks do not play a significant role in investment banking and they are not active abroad.

In both Germany and Switzerland, government-owned banks account for a substantial share of total assets (Table 1). The majority of these banks were founded in the 19th century by municipalities or districts in Germany and by cantons in Switzerland. The purpose of these banks was, and is, to encourage saving by the local population. However, in contrast to private-sector savings institutions, government-owned banks must accept certain public-service functions, such as promoting the development of the local economy or assisting disadvantaged groups. In Germany, these banks are chartered by the *Länder* (states) and can only operate within their home-*Land* (state). Although the individual German government-owned savings banks can hardly be regarded as universal establishments, they operate central institutions

[2]In Germany, financial institutions may not grant mortgage loans unless they are authorized to do so. No such restrictions exist in Switzerland.

(Landesbanken) placed at the level of the *Länder* and at the federal level. These central institutions initially were set up to provide payments services to their members, but later evolved into full-fledged universal institutions. Through these central institutions, the individual savings banks are able to offer universal banking services to their customers. Among the Swiss cantonal banks cooperation is less common. Only the largest cantonal banks come close to resembling universal institutions. They do play a limited role in underwriting domestic securities and in portfolio management, but are legally constrained to engage in foreign business.

Cooperative banks, like government-owned savings banks, are institutions focusing on the savings business. Although initially conceived as self-help organizations, which mainly accepted deposits from and lent funds to members of the cooperative, they gradually evolved into universal banks when they set up central institutions, as was done in Germany. In Switzerland, by contrast, cooperative banks remained less important, as indicated by their respective shares in total assets of the banking system (Table 1). Due to their small market share, Swiss cooperative banks have not expanded into universal banking to any great extent.

The remaining banking groups in Table 1 largely consist of specialized institutions involved in the most diverse lines of activity. In both Germany and Switzerland, private banks, whose importance has shrunk considerably, are active in portfolio management. Branches of foreign banks, though often part of a universal institution, typically also specialize. In Switzerland, they tend to concentrate on underwriting and portfolio management. Finally, in Germany, the category "other financial institutions" includes building societies, mortgage establishments, and other specialized institutions. In Switzerland, the groups of "other banks" and "finance companies," which include the subsidiaries of foreign banks, cover institutions involved in various activities, such as commercial banking, underwriting, securities trading, and portfolio management.

An analysis of bank earnings reveals further differences between the German and Swiss banking systems. Table 1 shows the share of commission income in net revenue, broken down by banking groups. Commission income covers fees obtained on such banking services as payments services, guarantees, foreign exchange and securities trading, underwriting, portfolio management, and financial derivatives. Aside from commission income, net revenue includes interest income on the banks' assets net of interest paid on the banks' liabilities. Therefore, institutions involved mainly in traditional commercial banking activities display a low ratio of commission income to net revenue.

Investment and trust banks, by contrast, display a high ratio, while truly universal banks occupy the middle range.

Table 1 points to two striking differences in the structure of German and Swiss banks' earnings. First, German institutions, as a whole, resemble more closely traditional commercial banks than their Swiss counterparts. In Germany, the average ratio of commission income to net revenue is much lower than in Switzerland. The relatively high Swiss ratio reflects the important role played by Swiss banks in underwriting, securities trading, and portfolio management. Second, in Germany, that ratio displays a much smaller variability across the various banking groups than in Switzerland. In Germany it fluctuates between 12 to 30 percent as compared to a range of 9 to 80 percent in Switzerland. Thus, while German banks, on average, are less universal than their Swiss counterparts, universal banking in Germany is more evenly spread across the various groups of financial institutions than in Switzerland.

A high ratio need not imply that the group concerned specializes in investment banking. Unfortunately, the available data on Switzerland do not provide a detailed breakdown of commission income by sources. There is little doubt that Swiss banks derive their commission income mainly from four sources: foreign exchange trading, underwriting, securities trading in the secondary market, and portfolio management. Separate data are available on commission income gained from foreign exchange trading. They indicate that big banks and branches of foreign banks are more heavily engaged in foreign exchange trading than the other groups. However, the patterns revealed by Table 1 are not altered much if the foreign-exchange component is eliminated, although the ratio of commission income to net revenue, for the Swiss banking system as a whole, drops from 44 to 33 percent.

While some specialized Swiss institutions act as pure investment banks, they typically combine investment and trust banking under one roof. Many of the specialized Swiss banks operate as portfolio managers. They are members of the domestic stock exchanges and, thus, provide both brokerage and portfolio management services to their clients. In most cases, they do not participate to any great extent in underwriting, which is dominated by big banks. Consequently, the strategy of specialization pursued by many of the smaller Swiss banks does not fit the Glass-Steagall mould. Rather, it has resulted in a separation of traditional bank borrowing and lending from investment and trust banking.

In summary, the German and Swiss experiences indicate that many banks choose to specialize even if legislation does not place any constraints on universal banking. Specialized banks tend to be small

institutions coexisting and competing with big universal banks. Although both the German and Swiss systems allow for specialization, there is little doubt that since the end of World War II, market forces have served to enhance the importance of universal banks and have permitted them to expand their sphere of influence.

The Growing Importance of Universal Banks

Despite the similarities between the German and Swiss banking systems, the trend toward universal banking has not taken the same form in both countries. In Germany, the shares of the various banking groups in aggregate assets, as shown in Table 1, has not changed much since the 1960s. In particular, the market share of the big German banks has remained relatively small as compared to that of their Swiss counterparts. Thus, in Germany, the trend toward universal banking did not increase the market share of big banks. Rather, as mentioned above, universality has been strengthened in two other ways: the larger regional banks have turned into truly universal institutions, and government-owned and cooperative banks through their central institutions have added universal features to their operations. Although the market shares of the various groups of banking institutions have not changed much, the number of German banks has shrunk substantially in the postwar period.

In Switzerland, universality was strengthened largely by big banks expanding their market share at the expense of smaller institutions. At the end of World War II, the big banks accounted for roughly 25 percent of aggregate assets. In 1991 that ratio has risen close to 50 percent of aggregate assets (Table 1), while regional and cantonal banks saw their market shares fall drastically. As a result, the big banks now occupy a dominant position in the Swiss financial system.

Universal Banking and Capital Markets

Many students of financial markets have pointed to the striking difference in the role played by nonbank financial intermediation in the United States and Germany (see, for example, Kregel 1992). In the United States, nonfinancial corporations raise the bulk of their required funds on the capital market.

Table 2 provides data on the capital structure of U.S. nonfinancial corporations outside the agricultural sector. It shows the shares of equity and various types of debt in total capital (sum of equity and debt). According to Table 2, U.S. nonfinancial corporations raised over 50 percent of their capital in the form of equity. Bonds are a far less significant source of finance, but their importance has increased since 1975. Loans from banks and other financial institutions, by

TABLE 2

CAPITAL STRUCTURE OF NONFARM NONFINANCIAL CORPORATIONS[a] IN THE UNITED STATES
(Percent, End of Year)

	1975	1991
Equity[b]	67.5	53.4
Bonds[c]	10.8	15.7
Open-Market Papers	0.4	1.3
Mortgages	4.9	2.9
Bank Loans[d]	6.3	7.5
Other Loans[e]	1.0	3.2
Trade Debt	7.3	9.2
Other[f]	2.0	6.9

[a]Only nonfarm nonfinancial corporations are listed in the source given below.
[b]Equity computed as the net worth of nonfarm nonfinancial business.
[c]Includes both tax-exempt debt and corporate bonds.
[d]The figure for bank loans includes acceptance liabilities to banks as reported in the source given below.
[e]Includes foreign loans, nonbank financial loans, and U.S. government loans.
[f]Includes taxes payable, and miscellaneous liabilities.
SOURCE: Board of Governors of the Federal Reserve System (1992: 23–25).

contrast, only account for roughly 10 percent of total capital. Table 3 exhibits analogous data on German nonfinancial corporations. The important role played by German banks in lending to nonfinancial corporations is clearly revealed by that table. Bank loans account for over 40 percent of total capital. More than 60 percent of bank loans are provided in long-term form. Conversely, only about 25 percent of capital consists of equity, while bonds and short-term securities are an insignificant source of finance.

The patterns revealed by Tables 2 and 3 are mirrored by the equally striking differences in the composition of financial assets held by the ultimate lenders to nonfinancial corporations. Table 4 displays data on the structure of financial assets in the hands of U.S. private households, as well as U.S. pension funds and insurance companies. It testifies to the importance of stocks in the portfolios of both private households and institutional investors. Private households allocate 25 to 33 percent of their financial assets to deposits (including currency) and securities respectively, while the institutional investors favor securities.

In Germany, by contrast, private households place roughly 50 percent of their financial assets with banks and building societies, while their holdings of securities account for less than 25 percent of the

TABLE 3

CAPITAL STRUCTURE OF NONFINANCIAL CORPORATIONS IN GERMANY
(Excluding Construction Sector, Percent, End of Year)

	1972	1991[a]
Equity	27.0	26.3
in Bank Portfolios	n.a.	2.6
Bonds	3.5	2.4
Short-term Securities	0.5	—
Bank Loans	46.2	42.9
Short-term	18.9	15.4
Long-term	27.3	27.5
Loans from Building Societies and Insurance Companies	3.8	2.8
Other	19.0	25.6

[a]Excluding the former East Germany.

SOURCES: Deutsche Bundesbank (1973: 56; 1993: 92). The percentages shown for the end of 1972 are calculated from revised data supplied by the Bundesbank. The percentages are based on outstanding stocks of securities, valued at market prices. The category "Other" covers liabilities vis-à-vis corporations, public authorities, social security funds and foreigners.

total (Table 5). In particular, stocks in the hands of German private households amount to merely 5.6 percent of the total, as compared to 23.8 percent for their U.S. counterparts. However, from 1975 to 1991, German private households increased somewhat the share of securities in aggregate financial assets. As far as institutional investors are concerned, a comparison of German and U.S. patterns is hampered by the fact that in Germany pension funds play a less significant role than in the United States.[3] The data in the last two columns of Table 5 reveal a pattern similar to that of private households, except that direct lending by institutional investors to the ultimate borrowers (mostly mortgage loans and loans to employers) is more important in Germany than in the United States.

In view of the structural differences revealed by Tables 2 through 5, the question arises whether the preponderance of bank-induced financial intermediation observed in Germany is characteristic for universal banking systems. Do universal banks inhibit the development of capital markets and nonbank financial intermediation? To answer

[3]In Germany, pensions are frequently provided directly by former employers or by plans set up by the former employer with insurance companies.

TABLE 4

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN THE UNITED STATES
(Percent, End of Year)

	Private Households[a]		Pension Funds and Insurance Companies[b]
	1975	1991	1991
Stocks[c]	25.1	23.8	30.3
Corporate Bonds[d]	2.9	1.5	22.8
Securities of U.S. Government, U.S. Agencies, and State & Local Government[e]	7.4	9.8	20.9
Open-Market Papers	0.3	1.3	2.5
Loans	2.2	1.8	10.2
Currency and Deposits	36.0	26.0	5.5
Insurance and Pension Reserves	24.0	33.3	—
Other[f]	1.7	2.4	7.9

[a]Households include both personal trusts and nonprofit institutions. Since personal trusts are included in the total for households, there is no separate entry for them. Equity in noncorporate business is excluded.
[b]Covers public and private pension funds, life and other insurance companies.
[c]Includes mutual fund shares.
[d]Includes foreign bonds.
[e]Tax exempt securities are assumed to be state and local bonds.
[f]Includes security credit and miscellaneous assets.
SOURCE: Board of Governors of the Federal Reserve System (1992: 15–17).

TABLE 5

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN GERMANY
(Percent, End of Year)

	Private Households		Pension Funds[a] and Insurance Companies	
	1972	1991[b]	1972	1991[b]
Stocks	8.4	5.6	9.8	15.8
Bonds	8.9	18.1	19.7	23.1
Bank Deposits	54.0	42.7	15.3	35.6
Deposits with Building Societies	7.8	4.0	—	—
Insurance	14.9	21.8	—	—
Loans	—	—	55.2	25.5
Other	6.0	7.9	—	—

[a]Only legally independent pension funds.
[b]Excluding the former East Germany.
SOURCES: Deutsche Bundesbank (1973: 56; 1993: 92). Percentages for the end of 1972 are calculated from revised data supplied by the Bundesbank. Securities are valued at market prices. "Loans" only cover the portion extended to nonbanks. Loans to banks are subsumed under "bank deposits."

this question, it is once again useful to compare the German and Swiss experiences.

Unfortunately, this comparison is complicated by various gaps in the Swiss data. It is possible to estimate the structure of the *increase* in capital of Swiss nonfinancial corporations over the period extending from the end of 1973 to the end of 1988. The following types of data are available on the major sources of corporate finance: (1) rough estimates of the increase in equity and bonds over that period, (2) stock data on loans of pension funds to nonfinancial corporations, and (3) stock data on bank loans to nonfinancial corporations for the period beginning with the end of 1977. Other sources of finance were probably unimportant.[4] Since the data from the various sources are not homogeneous, the percentages shown in Table 6 are based on the increase in equity, bonds, and pension-fund loans over the period

[4]Swiss nonfinancial corporations do not issue short-term securities such as commercial paper. A turnover tax on securities transactions which was partly eliminated on April 1, 1993, imposed high costs on the issue of short-term securities. It remains to be seen whether the modification of the turnover tax will breathe life into the Swiss money market.

TABLE 6

CAPITAL STRUCTURE OF NONFINANCIAL CORPORATIONS IN SWITZERLAND
(Percent, 1973–88)

Equity	39.9 – 47.9
in Bank Portfolios	0.6 – 0.7
Bonds	14.8 – 17.1
Bank Loans	30.5 – 41.4
Loans from Pension Funds	3.9 – 4.5

SOURCES AND ESTIMATION METHOD: We used data assembled by Dominik Egli (1991) on issues of equity and bonds, net of conversions, by Swiss corporations over the period extending from the end of 1973 to the end of 1988. The data on equity include an estimate of cumulative retained earnings over that period. From Egli's estimate we deduct the increase in equity (including reserves) and bonds (excluding cash bonds), as reported by Swiss banks and finance companies (excluding cantonal banks and foreign-owned banks) in their balance sheets over the same period (Swiss National Bank 1989: Tables 18.6 and 18.7; 1974: Table 22). For loans from pension funds, we used the difference between stocks held at the end of 1988 and 1973. No data are available on stocks at the end of 1988. Therefore, we inserted the corresponding average for the end of 1987 and 1989 (Eidgenössisches Volkswirtschaftsdepartement 1976: 212, Table 2; Bundesamt für Statistik 1991: Table 4). These data represent borrowings of nonfinancial corporations from their own pension funds. For bank loans to nonfinancial corporations, we employed either the stock at the end of 1988 or the difference between the stocks at the end of 1988 and 1977 (Swiss National Bank 1978: 72; 1989: Table 33.4).

1973–88. Furthermore, for bank loans to nonfinancial corporations, we estimate the upper and lower bounds of the true increase over that period. The former equals the stock at the end of 1988, whereas the latter represents the increase over the period extending from the end of 1977 to the end of 1988. This procedure yields the percentage ranges for the four sources of corporate finance displayed in Table 6.

Interestingly, the capital structure of Swiss nonfinancial corporations looks like a mix of U.S. and German patterns. In Switzerland, the share of equity in total capital is lower than in the United States, but the two countries' shares of fixed income securities are about equal. Moreover, for the share of bank loans, the Swiss percentage figure is closer to German than U.S. levels.

Table 7 exhibits data on the composition of financial assets in the hands of Swiss private households and institutional investors. The data suffer from various defects listed in the legend to that table, but they should portray the structure of financial assets with reasonable

TABLE 7

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN SWITZERLAND
(Percent, End of 1990)

	Private Households	Pension Funds and Insurance Companies
Stocks	15.1	10.0
of which Foreign	9.0	5.2
Bonds	16.6	30.8
of which Domestic Government	0.3	2.5
of which Foreign	14.3	4.0
Cash Bonds	5.2	7.2
Loans	—	36.2
of which Mortgage Loans	—	15.2
Bank Deposits and Fiduciary Accounts	25.6	11.9
of which Fiduciary Accounts	3.0	0.4
Insurance and Pension Reserves	36.8	—
Other	0.8	3.8

SOURCES AND ESTIMATION METHOD: Data on securities, including cash bonds, held by private households only cover the portion managed by domestic banks (Source: unpublished data collected by the Swiss National Bank). There are also households managing their securities on their own, but no data exist on the size of these holdings. Data on bank deposits and fiduciary accounts by private households are from Swiss National Bank (1991: Table 33.4). Claims of private households on insurance companies are assumed to equal the following items, as published in Bundesamt für Privatversicherungswesen (1992: Table 2.3.3): reserves, technical provisions and customers' claims on the surplus of life insurance companies. The estimate, thus obtained, is likely to overstate claims of private households because it includes claims of foreigners on domestic life insurance companies. Claims of private households on pension funds are assumed to equal capital (free and restricted) of these funds, as shown in Bundesamt für Statistik (1992: Table 5). For the securities holdings of insurance companies (life and casuality) and pension funds, see Tables 2.3.2 and 4 in the last two sources mentioned above. These two sources only contain the totals of stocks and bonds held by insurance companies and pension funds. The breakdown shown in Table 7 is estimated from the unpublished source mentioned at the outset. This source suggests that the bulk of securities held by Swiss insurance companies and pension funds is managed by domestic banks. For data on bank deposits and fiduciary accounts by insurance companies and pension funds, see Swiss National Bank (1991: Table 33.4).

accuracy. Once again, the Swiss patterns differ from those of Germany. As far as asset preferences of private households are concerned, there are greater similarities between Switzerland and the United States than between Switzerland and Germany. Swiss private households keep about 30 percent of their financial assets in the form of bank deposits, including fiduciary accounts and cash bonds, a share somewhat higher than in the United States, but considerably lower than in Germany. Cash bonds, which are issued by Swiss banks mainly to finance mortgage loans, must be subsumed under bank liabilities. However, in Switzerland, the private households' share of securities is lower than in the United States but, higher than in Germany. Moreover, private households in Switzerland display a strong preference for bonds, albeit not as strong as in Germany.

By contrast, there are marked differences between the asset preferences of Swiss and U.S. institutional investors. In Switzerland, institutional investors hold roughly 40 percent of their assets in the form of securities, as compared with over 70 percent in the United States. Conversely, loans by institutional investors to the ultimate borrowers are more important in Switzerland than in the United States. Bank deposits are also more important in Switzerland, but less so than in Germany.

The relative importance of Swiss capital markets is confirmed by Table 8, presenting data on the major stock exchanges of the three countries under review. Table 8 suggests that in Switzerland stock exchanges play a much larger role than in Germany. At the end of 1990, the market value of stocks, issued by domestic companies and listed on the major domestic stock exchanges, amounted to as much as 88 percent of GNP in Switzerland, as compared to 26.8 percent in Germany, and 49.6 percent in the United States. Consequently, the Swiss experience suggests that universal banking may be consistent with a well-developed domestic capital market. The evidence of Table 8 also agrees with our earlier conclusion about the relatively strong weight of commission income in the net revenue of Swiss banks.

Tables 3 and 6 also provide information on bank ownership of equity in German and Swiss nonfinancial corporations. In Switzerland the share of equity owned by banks is negligible, but even in Germany it is small. We do not know how the evidence of Table 3 agrees with the frequently expressed view that the participation of German banks in domestic industry constitutes an important phenomenon.[5] Be that

[5]Kregel (1992) argues that the official German data, as reported in Table 3, understate bank ownership of corporate equity. In Switzerland, banks are discouraged from acquiring controlling equity stakes in nonbank corporations. The capital-adequacy rules stipulate that such stakes be covered fully by the bank's own capital.

TABLE 8

STOCK EXCHANGES IN THE UNITED STATES, GERMANY AND SWITZERLAND, 1990

	USA[a]	Germany[b]	Switzerland[c]
Number of Companies Listed (End of Year)			
Domestic	6,414[d]	649	182
Foreign	351	555	240
Market Value of Stocks of Listed Domestic Companies (End of Year)			
Billions of U.S. Dollars	3,105	343	167
Percent of GNP	49.6	26.8	88.0

[a]New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and National Association of Security Dealers Automatic Quotation (NASDAQ).
[b]Stock exchanges in Frankfurt, Berlin, Bremen, Düsseldorf, Munich, Hamburg, Hannover, and Stuttgart.
[c]Stock exchanges in Zurich, Geneva, and Basle.
[d]Data for AMEX include foreign stocks.
SOURCE: Goldman Sachs (1991: 4,9,11,17,96,124,128).

as it may, there is little doubt that German and Swiss banks wield considerable influence over industry. Bank representatives sit on the boards of major domestic companies and vice versa. Moreover, in Germany, the *Depotstimmrecht*, that is, the right of a bank to represent the owners of shares held in bank-managed portfolios, is also an important control instrument. In Switzerland, the *Depotstimmrecht* used to be important too, but recent legislative reforms have curbed the banks' ability to throw their weight around corporate board rooms.

Some Historical Considerations

Until the early 1930s, the U.S. banking system incorporated crucial elements of universality. Many commercial banks engaged in investment banking activities. However, these banks were not organized along the lines of German- and Swiss-style universal institutions. They conducted their investment banking operations in legally separate securities affiliates.[6] The banking crisis of the 1930s provided the impetus for a drastic reform of U.S. banking legislation, including the passage of the Glass-Steagall Act of 1933. The resulting separation of commercial and investment banking has remained a feature of the U.S. financial system ever since.

In Germany and Switzerland domestic banks were also seriously afflicted during the Great Depression. The German government was forced to take over most of the big banks in order to forestall a complete collapse of the domestic banking system. However, these banks were reprivatized during the latter part of the 1930s (Francke and Hudson 1984: 7–13; Kregel 1992: 235–36). In Switzerland about 10 percent of the banks failed. As in the United States, the financial crisis resulted in major reforms of German and Swiss banking legislation. The German Banking Act (*Kreditwesengesetz*) of 1934 considerably strengthened bank supervision by establishing a single agency with broad supervisory powers over the financial system. In Switzerland the Banking Act of 1934 transferred the authority for supervising banks from the cantons to the federal government. However, in contrast to the United States, both Germany and Switzerland maintained their universal banking systems.

Why did Germany and Switzerland respond differently to the banking crisis than the United States? Examining the German experience, J.A. Kregel (1992: 235–36) argues that

> in difference from the U.S., the German banking crisis of the 1930s was not primarily a result of fraud or use of deposit funds for

[6]The National Banking Act was interpreted to imply that national banks could not operate their securities business directly (see Benston 1990: 25).

speculation in capital markets. It was the result of hyperinflation in the inter-war period and the extensive reliance on foreign borrowing to finance war reparations. The crisis was set off by an outflow of foreign and domestic funds.

The causes of the U.S. banking crisis, mentioned by Kregel, are those stressed by many contemporary observers. In the United States, the advocates of banking reform typically traced the origin of the crisis to massive losses at the securities affiliates of the commercial banks, due to fraudulent or reckless behavior and excessive speculation. In their view, the entire financial system was thrown in the abyss as these difficulties spilled over to the commercial banks. Barriers between commercial and investment banking, they maintained, would help to prevent future crises. In Germany, by contrast, the crisis stemmed from losses in the traditional lending business of the banks. It was magnified by the high indebtedness, notably vis-à-vis foreigners, of German industry. In Switzerland too, losses on loans were regarded as the principal cause of the crisis.

New research on the U.S. banking crisis of the 1930s has cast doubt on the stories told by contemporary observers. In a study of the investment banking activities of the national banks before 1933, Eugene White (1986) shows that institutions without securities affiliates had a much greater tendency to fail than those actively engaged in the securities business. Thus, the significance of losses arising from the banks' securities operations was probably exaggerated. As in Germany and Switzerland, it appears that the origins of the crisis must be sought mainly in the commercial banking practice of U.S. financial institutions rather than in their investment activities.

Furthermore, in a careful study of the debates preceding U.S. banking reform, George Benston (1990) demonstrates that many of the charges directed at pre-1933 U.S. universal banks were ill-founded. He points out that many charges, though legitimate, had little to do with universal banking. They pertained to fraudulent or irresponsible practices, flawed internal control procedures, and inadequate supervision of banks in general, rather than to specific problems arising from universality. Another set of charges identified by Benston concerned the difficulties associated with the particular institutional setup of U.S. universal banking, that is, with the existence of legally separate securities affiliates. And finally some charges referred to defects of universality as such. Since our study deals with the German and Swiss experience, it is these defects that are of particular interest. Broadly speaking, the critics of universal banks voiced four kinds of concerns:

- Commercial banks engaged in the securities business are liable to incur greater risk than institutions that stick to deposit taking

and lending. Therefore, universal banks are prone to increa the likelihood of losses by their depositors.
- Because of the increase in risk, universal banks complicate th tasks of central banks in their capacity as lenders of last resort
- Universal banks are likely to be entangled in various conflicts o interest vis-à-vis their creditors and debtors.
- Universal banks, due to their size, may further the concentration of power and inhibit competition.

Possible conflicts of interest may arise from the fact that officials of universal banks may gather inside information from their loan departments on customers whose securities they underwrite. They may use that information to make inside profits on the sale of these securities. Universal banks also may encourage their debtors to fund bad loans by issuing securities. As underwriters of these securities, they may provide misleading information to potential buyers and thus shift credit risk to the general public. Finally, universal banks may try to increase profits from their securities business by providing misleading information on the quality of the paper offered to the public. In this way, they may induce unwitting depositors to purchase bad securities or they may unload bad securities on their trust departments.

In Germany and Switzerland, these alleged defects of universal banking did not loom large in the public debate on banking reform. The Swiss Banking Act of 1934 was conceived by Julius Landmann, an outstanding economics professor at the University of Basle. In the period 1910–14, Switzerland was shaken by a serious banking crisis that resulted in numerous bank failures. In response to that crisis, the Swiss government asked Landmann to work out a proposal for a federal banking act.[7] Since Landmann's report was highly controversial, the government declined to act on its recommendations. Instead, it kept his report secret for a lengthy period of time. His proposal was implemented only after another banking crisis had erupted in the early 1930s.

In his report, Landmann (1916: 32–36) attributed the banking crisis of 1910–14 to a variety of causes. They included flaws in the internal organization of banks, especially inadequate division of responsibilities among bank officials and poor internal controls. Landmann also uncovered various shortcomings in the lending practices of Swiss banks.

[7]Landmann (1910) also wrote a study on Swiss banking law for the U.S. National Monetary Commission that recommended establishing the Federal Reserve System.

Many banks granted loans in regions in which they normally did not operate. Moreover, they often failed to diversify sufficiently their loan portfolios and tolerated overly large exposures to individual borrowers. They also engaged in excessive maturity transformation and did not exercise sufficient care in monitoring the interest-rate risk they incurred. Frequently, their own capital was inadequate to protect them against risks arising from their lending. History repeated itself two decades later as the banking crisis of the 1930s was triggered by the same malpractices that had afflicted the Swiss financial system in the period 1910–14 (see Urech 1944: 3–9).

Thus, Landmann (1916: 69) and other observers attributed the Swiss banking crises to flaws in the internal organization and in the lending practices of financial institutions rather than to shortcomings in their securities business. Nevertheless, Landmann (1916: 63–69) was aware of the problems that might arise from universal banking. He explicitly discussed the question of whether Switzerland should abandon universal banking and adopt the British system of separation. In his view, separation was ideally suited for a mature economy such as Great Britain, but not for a country like Switzerland that, in his time, was still in an early stage of industrial development. To improve the performance of universal banks, Landmann (1916: 94–112) proposed establishing a government agency, similar to the Security Exchange Commission (SEC), that would be empowered to oversee securities markets and to deal with such problems as conflicts of interest.[8] While Landmann's proposal for tightening bank supervision was eventually implemented, securities markets were left largely unregulated. Only recently did the Swiss government decide to propose legislation to parliament for improving supervision of securities markets.

Germany too experienced occasional debates about possible defects of universal banking. For example, in 1974, the federal finance minister commissioned a study of the various problems associated with universal banks, such as conflicts of interest and concentration of power resulting from their equity stakes in nonfinancial corporations. The study group concluded that the objections to universal banking, for the most part, were not borne out by the facts (Francke and Hudson 1984: 45–46).

[8]Complaints about conflicts of interest were voiced from time to time. See, for example, Schulthess (1934). Furthermore, Swiss corporations for a long time were notorious for their uninformative financial statements, a practice already criticized by Landmann (1916: 69–78). The quality of Swiss financial reporting is now improving.

Are the Objections to Universal Banking Justified?

In the previous section we identified four major objections to universal banking. In his study of the Glass-Steagall Act, George Benston (1990: chap. 10) reviews critically these objections. In his view, the case for separation of commercial and investment banking rests on weak foundations. We can now supplement Benston's comprehensive analysis with a few observations drawn from the Swiss experience.

Riskiness and Lender-of-Last Resort Problems

Are universal banks prone to incur excessive risks and, thus, to jeopardize the stability of the financial system? Benston (1990: 149–59) examines various studies that attempt to answer this question by drawing on U.S. evidence. Most of these studies, he concludes, reject the view that universality enhances the riskiness of banking operations.

TABLE 9

CROSS CORRELATIONS OF VARIOUS NET REVENUE COMPONENTS OF SWISS BANKS
(Annual Logarithmic First Differences, 1950–91)

	IL	II	IC
IL	1		
II	−0.17	1	
IC	−0.03	0.32	1

SOURCE: See Table 1.

The available Swiss evidence leads to similar conclusions. Table 9 presents cross correlations between logarithmic first differences in various components of the Swiss banks' net revenue. The latter is divided into net interest income from loans (*IL*), other interest income (*II*), and income from commissions (*IC*). As we noted above, *IC* is not attributable solely to investment banking activities. A similar problem arises with regard to *II*. Nevertheless, the correlations between *IL*, on the one hand and *II* and *IC*, on the other, should shed some light on the riskiness of universal banking. If these correlations assume only a small positive or even a negative value, combining commercial and investment banking under one roof would actually decrease risk. As shown in Table 9, the two correlation coefficients assume slightly negative values. Thus, there is no evidence to suggest that in Switzerland universal banking increases risk.

The evidence from Table 9 is corroborated by the current structural changes in the Swiss banking system. As a result of the recent collapse of the real estate market, many Swiss banks are compelled to make

provisions against bad mortgage loans. Regional and cantonal banks are particularly afflicted by these problems. For this reason, the number of regional banks is shrinking substantially, mainly as a result of mergers within that group or takeovers by bigger institutions. The big banks, by contrast, are weathering their real-estate problems without much difficulty, due to their ability to diversify risk among a wide range of activities.

Since universal banks are better equipped to diversify their risk than the specialized institutions, universality as such does not complicate the lender-of-last-resort role of central banks. However, problems may arise from the fact that universal banks are typically large. If large institutions run into solvency problems, central banks may be confronted with the dilemma of "too big to fail." In principle, these institutions should be closed, but such closures might send shockwaves through the entire financial system and impair its stability. Clearly, the "too big to fail" dilemma is not related to the universality of banks but to their size.

Conflicts of Interest

Universal banking may give rise to conflicts of interest that need to be taken seriously. It would not be difficult to find examples of conflicts of interest in the history of Swiss banking. Nevertheless, two reasons lead us to believe that in Switzerland conflicts of interest today create far less serious problems than in the past.

First, Swiss regulations of securities markets are being strengthened considerably. Insider trading is now a criminal offense in Switzerland. Furthermore, the government is proposing legislation that would guarantee transparency of stock exchange trading, as well as adequate financial reporting by listed companies. A second reason, in our view, is even more important than the first one. Market forces themselves support the legislative efforts for diffusing conflicts of interest and preventing other abuses in securities markets. For example, if a universal bank attempts to hide blunders in underwriting by shifting unsaleable securities to its trust department, its customers are likely to be confronted with relatively low returns on their portfolio investments. Competitors, including specialized banks, have an incentive to bid away customers from the low-performing universal institution. Thus, market forces tend to induce universal banks to eradicate conflict-of-interest problems.

This process is very much at work in Switzerland. It is fuelled by a number of new developments in domestic and international financial markets:

- Institutional and individual investors place much greater emphasis on performance than in the past. Many investors today deal with a multitude of banks, including specialized institutions. They compare the returns on their various portfolios and penalize the low performers. The house-bank system, still in place in Germany, is not common in Switzerland.
- Price-fixing agreements and other cartel arrangements have been abolished in Swiss financial markets. Competition among domestic financial institutions is much more vigorous than in the past. The enhanced competition also keeps the big universal banks on their toes.
- As a result of the globalization of financial markets, Swiss banks must increasingly compete in international markets.

Although financial institutions are closely supervised in Switzerland, barriers to entry into the banking industry are not high. If big banks leave unexploited profit opportunities, new institutions may enter the market to fill these niches. Switzerland has also traditionally taken a liberal attitude towards the influx of foreign banks, who have invigorated competition in the domestic financial market.

Concentration of Power

Students of the German banking system frequently express concern about the concentration of power in the hands of the big domestic universal institutions. In Switzerland, these concerns are less pronounced even though the big Swiss institutions account for almost 50 percent of the domestic banks' aggregate assets. The intensification of competition and the regulatory changes mentioned earlier have curbed the power of the big Swiss banks.

A review of the literature (e.g., Benston 1990: 194–99; Pozdena and Alexander 1992: 571–75, 583) suggests that the critics of the German banking system tend to overstate the problems arising from the banks' influence on the economy. On the contrary, the evidence seems to support the view that the German system has promoted economic growth by enhancing the efficiency of the domestic economy. According to Pozdena and Alexander (1992: 574), German banks through their ability to monitor the management of nonfinancial corporations improve the allocation of credit. They also help to alleviate agency problems that would likely arise if ownership of stock issued by nonfinancial corporations were widely dispersed.

The Future of Universal Banking

We have argued that in Germany and Switzerland the importance of universal banking has grown since the end of World War II. Will

this trend continue so that universal banks could completely overwhelm the specialized institutions in the future? Are the specialized banks doomed to disappear? This question cannot be answered with a simple "yes" or "no". The German and Swiss experiences suggest that three factors will determine future growth of universal banking.

First, universal banks no doubt will continue to play an important role. They possess a number of advantages over specialized institutions. In particular, they are able to exploit economies of scale and scope in banking. These economies are especially important for banks operating on a global scale and catering to customers with a need for highly sophisticated financial services. As we saw in the preceding section, universal banks may also suffer from various shortcomings. However, in an increasingly competitive environment, these defects will likely carry far less weight than in the past.

Second, although universal banks have expanded their sphere of influence, the smaller specialized institutions have not disappeared. In both Germany and Switzerland, they are successfully coexisting and competing with the big banks. In Switzerland, for example, the specialized institutions are firmly entrenched in such areas as real estate lending, securities trading, and portfolio management. The continued strong performance of many specialized institutions suggests that universal banks do not enjoy a comparative advantage in all areas of banking. As a matter of fact, a substantial body of research indicates that most big banks have already grown beyond the point at which further expansion in their market shares results in significant returns to scale or scope. On the contrary, a continued expansion is often detrimental to the banks' profitability as decisionmaking within the institution becomes bureaucratic and inflexible. Thus, even if legislation allows for universal banks, many financial institutions will elect to specialize. However, the pattern of specialization generated by market forces need not resemble the Glass-Steagall type of separation of commercial and investment banking. German and Swiss experiences strongly suggest that banking activities will be separated along different lines.

Third, universality of banking may be achieved in various ways. No single type of universal banking system exists. We have shown that the German and Swiss universal banking systems differ substantially in this regard. In Germany, universality has been strengthened without significantly increasing the market shares of the big banks. Instead, the smaller institutions have acquired universality through cooperation. They have set up central institutions conducting those banking activities that are subject to significant returns to scale and scope. In Switzerland, the cooperative approach has not worked as well as in

Germany. The smaller Swiss institutions find it difficult simultaneously to compete with one another in some areas of banking and to cooperate in others. For this reason, in Switzerland the growth in universality has been associated with a substantial increase in the market shares of the big banks. It remains to be seen whether the cooperative approach will survive in an environment of highly competitive and globalized banking.

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