"THE SPECIALIZATION OF FINANCIAL INSTITUTIONS, THE EEC MODEL"

by

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Summary

The completion of the internal banking market by 1992 is raising several supervisory issues concerning the fields of activities or powers that should be granted to financial intermediaries and industrial firms. The proposals of the European Commission and the economic rationale for bank regulation are reviewed in this paper.It is suggested that the financial activities of conglomerates can be deregulated as long as risk taking by banks can be monitored and as long as the banking affiliate in an holding company can be separated from the other entities.

The completion of the internal banking market by 1992 is raising important economic,managerial and supervisory issues concerning the fields of activities and powers that should be granted to financial intermediaries and industrial firms.

From an economic perspective,the integration of financial markets raises the issue of economic efficiency.Economic growth is supposed to be fostered through a better allocation of savings,a diversified supply of financial products and the achievement of economies of scale or scope in financial intermediation.This objective was already set in the 1983 White Paper calling for the integration of European Financial Markets.

At the managerial level,the enlargment of financial markets raises the issue of the best product mix to deliver on an appropriate scale.A large series of domestic and cross-border mergers and acquistions has already matched the impulse given by the European Commission.To illustrate the willingness of many institutions to operate on a European scale ,one can mention the acquisition of the Italian retail network of Bank of America by the German Deutsche bank,the alliance (cross--equity participation) between the Dutch Amro bank and the Belgian Generale Bank , the acquisition by Spanish Banco Santander of a 30 % stake in Istituto Bancario Italiano and the participation of Midland Bank in Euromobiliare.Recently,Deutsche Bank has created its own life insurance subsidiary in an effort to become a one stop ('allfinanz') services firm .The achievement of appropriate

size and diversification should help to realize the gains expected from European integration.

At the supervisory level,there is the need to ensure the stability of financial markets.Should regulators limit bank powers,that is the list of permissible activities ? Should they allow non-banks to enter into banking markets ? At the European level, there is the need to harmonize regulation,to define the scope of supervision and the responsibilities of the lenders of last resort and of the deposit insurance systems.An other issue, not discussed in this essay, is the necessity to control market power arising out of size or of the ability to use financial services to discriminate among customers.

The specialization of credit institutions is the object of this essay. The structure of the European banking industry and the proposals of the European Commission are reviewed in the first section .The economic benefits to be expected from 'despecialization' and the specific characteristics of the banking industry calling for regulations are addressed in the second and third sections.A proposal for an holding company structure follows.

The conclusions of the paper are as follows. The major reason for regulating banks should be the stability of banking markets.As lender of last resorts are necessary to prevent potential bank runs and as they should limit the size of their interventions,it is justified to contraint bank risks.However,

the financial activities of conglomerates can be deregulated as long as risk taking by banks can be monitored and as long as the banking affiliate in an holding company can be separated from the other entitities.

Section One : The European Banking Industry After 1992

Aggregate data on the banking systems in the twelve EEC countries,the United States,Japan and Switzerland are reported in Table One. Savings and mutual banks have been included as these institutions compete directly with commercial banks.The assets of these secondary banks represent 37 % of the assets of the commercial banking system in the European Community.

Insert Table One

Our count of banks in the EEC adds up to a total of 3064 banks, to be compared to around 17000 in the USA and 1165 in Japan.The size of the banking systems in relation to Gross Domestic Product is 151 % in the EEC,100 % in the USA and 224 % in Japan.'Banked' countries in Europe include Belgium,Luxembourg,Switzerland and the United Kingdom.Data on the market share of the five largest institutions are also reported.If there is evidence of concentration at the national level,this is not the case at the European Community level where the market share of the five largest institutions is 13 %.

One objective of the 1985 White Paper on the Completion of the Internal Market is the integration of financial markets in the Community.Responsible for the draft of directives,the European Commission makes a clear distinction between insurance companies,credit institutions and 'investment services' firms.The field of insurance will not be discussed in this essay.For sake of completeness,we can mention two major directives : the First Life and Non Life Insurance Directive which establishes the right of establishment and the Second Non Life Insurance directive which will allow a free supply of policies covering large risks.As far as the markets of mass risks and life insurance are concerned,we are very far from an integrated market as these policies are very much regulated at the national level for reason of consumer protection (Pool,1984 and Fitchew,1988).In the banking field,the major directive is the second banking directive adopted in june 1989,while in the investment banking industry,a proposal for a directive has been issued recently.In short, these directives provides for a single licence,home country control and mutual recognition of national regulations.

From the perspective of this paper -the specialization of financial institutions-,one has to be concerned with the list of activities included in a directive,the control exercised by the supervisors on shareholders and by the participations allowed.

The <u>second banking directive</u> applies to credit institutions as

defined in the first banking directive : "undertakings whose business is to receive deposits and other repayable funds from the public and to grant loans for its own account".The second banking directive includes most activities of universal banks,insurance activities excepted.The complete list of activities is provided in Table Two.

Insert Table Two

It provides that there will be free supply of services throughout the Community ,provided that the service is allowed by the home country regulator.

Articles 4 and 9 deal with the control of shareholders."Competent authorities shall not grant authorization permitting the taking up of the business of a credit institution before they have been informed of the identity of the shareholders ....The competent authorities shall not grant authorization if,taking into account the need to assure a sound and prudent management of the credit institution,they are not satisfied as to the suitability of the abovementioned shareholders or members" (art. 4) and "Member states shall require any physical or legal person who is considering the direct or indirect acquisition of a qualified majority in a credit institution to first inform the competent authorities ... Credit institutions shall each year furnish the competent authorities with the names of major shareholders; ...in ways which are likely to the detriment of the prudent and

sound management of the banking activities of the institution,the competent authorities shall ... bring such a situation to an end (art 9)".Of importance is a careful reading of the explanatory memorandum attached to the directive :" The ownership and control of a credit institution by non-banking interests is an issue of concern for the Community supervisors... Thus the risks of cross-financing and conflict of interest are particularly evident ... This procedure enables the competent authority to appraise the suitability of the shareholders and members and eventually to reject any particular group structures as improper at the moment of the setting up of the institution."Our understanding of this text and of their analysis by the Belgian Bankers Associations (1988) is that the home country regulator will be responsible for assessing the relationship between banks and non-bank ownership.There is no harmonisation in this field.It appears for example that the Bank of England would refuse any close association between banks and industry.

Article 10 is concerned with <u>participations in the non financial sector</u>."A credit institution shall not hold a qualified participation of an amount greater than 10% of its own fund in an undertaking which is not a credit institution or a financial institution... The total amount of qualified participations in undertakings other than credit institutions or financial institution .. shall not exceed 50 % of the own fund of the credit institution." But " Members states need not apply the limits if they provide that the qualified

participations in question are to be deducted when calculating the own funds of a credit institution".

The december 1988 version of the proposal for a directive on Investment Services applies to the activities listed in Table Three.

Insert Table Three

The contents of the 'Investment Services' directive is very similar to the one of the second banking directive in terms of single banking licence,home country control on shareholders,capital adequacy,risk management and compliance with prudential rules.The major difference is that substantial powers would be given to host authorities in terms of the design of the rules of conduct of business.These includes share registration and new issues procedure,securities prospectuses,investment management,investors protection,insider trading and related market practices.

To sum up this review of the EEC proposals on the specialization of financial intermediaries,it is clear that they open the way for close links between commercial banks,investment banks,insurance companies and industries ,but leave to the home country authorities the right to set their own rules.Different patterns could emerge with holding company

structure owning banks and non-banks (France and Belgium) or more direct participation (Germany).The issue of specialization is therefore still a national one.
A proper evaluation of the European directives should focus on the sources of economic efficiency to be gained from despecialization and on the sources of market failures which call for public regulation and limits on bank powers.

Section Two : The Sources of Economies of Scale or Scope in Banking

The analysis of economies of scale or scope in banking has to be analysed from the perspective of banks wishing to extend their powers and from the perspective of industrial corporations wishing to enter into the banking arena.

The bankers' perspective

A major condition for the viability of banks is to make sure that the mix of products is produced at the lowest possible cost.If this was not the case ,more efficient firms would enter the market.Two ways can be followed to achieve efficency.One is to reach an optimal size and benefit from economies of scale.The alternative way, as emphasized in the work of

Baumol,Panzar,Willig (1982),is to select the appropriate mix of products to benefit from economies of scope.

Economies of scale may exist for several reasons.In a study undertaken on the Costs of non-Europe,Pratten (1988) mentions indivisibilities and fixed costs such as research and computers costs that can be spread over a large volume of products.Moreover,large size firms can allow specialization of labor and superior organisation of production.Finally,and specific to banking, there can exist financial economies of scale when a large number of depositors reduces the uncertainty (variance) of deposits withdrawals and the need for costly liquid reserves. An other important source of financial economies of scale is that large banks,being not allowed to fail, benefit de facto from the implicit guarantee of the Central Bank and cheaper funding costs on the interbank market

Scope economies may result from the use of shared inputs in production.A same input can be used to provide several services.In banking, data storage and financial analysis can be used to provide multiple services : loans,deposits,underwriting,insurance and risk management products. Financial scope economies may come from diversification of risks, a stable return and a cheaper source of funds.Diversification is helpful in banking because it can reduce the risk of bank runs (Dermine,1988).A second type of financial economies of scope is that providing various services,such as lending and equity participation, can help to

solve a problem of asymmetric information . Cable (1985) has shown that equity participations of German banks facilitate the control of risks because bank representatives can sit on the board of industrial companies.Finally,marketing economies of scope are related to consumer convenience and 'one stop' shopping which reduces transaction costs.

The empirical evidence on economies of scale or scope in European banking is non-existent.One has to rely on work done in the United States.Recent studies by Berger-Hanweck-Humphrey (1988),Mester (1987) or Clark (1988) do not find major economies of scale for banks with deposits beyond ECU 100 millions.Moreover,they do not report evidence of economies of scope.However, one has to be careful with these results.If these studies are very meticulous about the definition of bank products (number of accounts or volume of intermediated dollars) and the distinction between branch and banking firm,they only look at banks with deposits below ECU one billion and the products analysed are deposits and loans.Large banks and products such as foreign exchange dealing,underwriting,management of pensions funds or mutual funds are excluded from these empirical analysis.Caution with these empirical studies is reinforced by recent results by S. Shaffer (1988) showing economies of scale for large banks in the United States. Finally,it must be remembered that these studies focus on scale economies in production ; marketing economies such as greater consumer convenience could be important.

The industrialists'perspective

Three arguments have been used to justify the willingness of industrial firms to enter the banking sector : The stabilization of net income,the ability to discriminate among customers and the implicit access to the guarantee provided by the lender of last resort.

A general argument for diversification of activities is the wish to stabilize net income when the returns on the various activities are imperfectly correlated.This argument is rather weak from a financial perspective. Indeed,the shareholders of firms can diversify themselves the risks in buying the shares of different companies and do not need a holding company to achieve this result.One needs real synergies to justify the entry of industrial firms into the banking world.

A second argument is that the supply of loans by the financial affiliate of an industrial firm can facilitate the sale of its own product,as is the case for instance in the automobile industry.This could be an example of real synergy, but one would like to make sure that the loans are not in fact subsidized (sold below cost), allowing de facto the firm to discriminate among customers.

Finally,there is the argument that the firm would benefit from cheaper funding from its bank affiliate.As theory shows,financial gains would be captured because the reduced profitability and solvency of the bank could have a small effect on its funding costs.This is so if the implicit

guarantee granted by the lender of last resort is perceived by the market as quasi-certain.

Although the empirical evidence about the economic gains to be expected from size and multi-product firms is non-conclusive,there remains the important question about the economic rationale for regulating bank powers and the linkage between commercial banking,investment banking and industry.

Section Three : The Economics of Banking Regulation

Following the approach proposed in Baltensperger-Dermine (1987),further expanded by Eisenbeis (1987), we review the major services provided by banks and analyse the potential sources of market failure.

Although the services provided by banks are interrelated,it is convenient to distinguish four categories : portfolio management,payment (transmission) mechanism,risk sharing and monitoring or information-related services.

Portfolio management : At low cost,investors can acquire a diversified portfolio of liabilities issued by deficit spending units.The pure case is the unit trust,SICAV or mutual fund which supply diversified portfolios to the holders of shares.

Payment mechanism : A second role for banks in the economy is the management of the payment system,that is to facilitate and keep track of transers of wealth among individuals.This is the bookeeping activity of banks realized by debiting and crediting

accounts.

Risk sharing services : An essential function of banks is to transform the risks faced by the parties,that is to supply risk sharing contracts.First,banks not only supply a diversified asset,they also organize efficiently the distribution of the risky income earned on the asset pool.The deposit holders receive a fixed payment while the shareholders receive the residual income.Other insurance services would include liquidity insurance (option for the deposit holder to withdraw quickly at face value) and interest rate insurance (floating rate lending with various ceilings on interest rates).

Monitoring or information-related services : Banks perform a useful function in reducing the costs of screening and monitoring borrowers.As Diamond (1984) shows,private information held by borrowers results in contracting problems and the delegation of screening and monitoring to banks is an efficient allocation mechanism.

As has been discussed in the literature (f.i. Fama,1980),if banks were to provide only the first two services -portfolio and transmission-,there would be no special need for banking regulation.However,the recent literature on insurance and monitoring services shows that the contract that emerges -illiquid loans financed by short term deposits- creates a potential market failure and a need for public intervention.Three independent explanations have been advanced : the public good character of information gathering and monitoring,the macroeconomic externality resulting from a bank

default and the potential for bank runs and systemic crisis.

Information and consumer protection

The first argument is that the evaluation of bank risks is a costly activity which has the nature of a public good.Once it is produced,it is available to consumers at very low transfer cost.As such the monitoring and evaluation of banks should not be undertaken by each depositor but could be delegated to a public agency or a private rating firm.Furthermore,since small account holders may find the cost of interpreting the rating high and/or since they care about risk free deposits only,one could create risk free banks,that is intermediaries investing in risk free assets only.Depositors would have the choice between banks offering a higher but risky return and those providing quasi-risk free deposits.
Our view on public information is that ,in this respect, the banking industry does not differ much from any other industry.As such,this does not require public intervention,besides what is being required for the securities industry in terms of disclosure of information.

Macro-domino externality

The second possible source of market failure is that the insolvency of one bank or group of banks (domino effect) is costly because information on borrowers is being lost.Borrowers

would need to turn to other banks at more expensive credit terms.This produces a macroeconomic effect which is not internalised by the borrowers.More expensive credit terms imply lower investment and unemployment.Although it is likely that large bank failures would have macroeconomic effects,we find one reason to disregard the argument.Insolvent banks are taken over by other banks in most cases,precisely to avoid the costs arising out of loss of information .Therefore,one has to rely on other sources of market failures to justify permanent banking regulation.

Bank runs

This argument, recently formalised by Diamond-Dybvig (1983), is that an important activity of banks is to finance illiquid assets (bank loans) with short term deposits.This creates the potential risk that savers run to withdraw their funds.A run can be triggered by bad news about the value of bank assets or by any unexplained phobia.In both cases,there is a loss since illiquid assets may have to be sold at a loss.A market failure occurs because a cooperative solution among depositors can not be enforced.Collectively,there is no incentive to run but ,individually, there is the incentive to be the first on the line to collect the deposit at full face value.In our view ,it is the financing of illiquid assets with short term deposits and the potential for bank runs which explains the need for

public intervention and the establishment of a safety net to guarantee the stability of the financial system.

In most European countries,the public intervention has taken the form of discretionary interventions by the lender of last resort.Recently,deposit insurance systems have been created in several European countries .A recommendation on the creation of deposit insurance systems in each of the Twelve Members has been endorsed by the European Council.Although it is not the object of this essay to discuss the establishment of deposit insurance,let say that they will not create stability since thery are completely unknown by the public,their coverage varies across European countries (from ECU 10585 in Spain to ECU 57970 in France) and their coverage is small (even incomplete in the United Kingdom).This implies that the major public tool to prevent bank runs and costly liquidation of assets remains the lender of last resort function of the central bank (Baltensperger-Dermine,1989).As it is well known that implicit guarantees on deposits reduce the private market incentives to monitor the risk taken by banks and price it correctly into higher deposit rates (the so-called 'moral hazard' problem),there is the necessity for central banks to limit the size of their 'umbrella' and to introduce various types of regulation.This includes traditionally ratios on capital and liquidity plus large risk exposure.It involves also the specialization of financial intermediaries and the separation between banking and commerce.

Section Four : An Holding Company Structure

A major issue for supervisors is the necessity to balance the economic benefits arising out of economies of scale or scope with controls on risk taking.As Merton (1977) has shown,the value of the insurance guarantee granted by the lender of last resort is directly related to profitability,the level of equity and the global riskiness of an institution.This framework emphasizes two aspects : the first is that control of risks may be counterproductice if it reduces profitability.Second as has been emphasized by Schaefer (1987),more attention should be paid to diversification,not just to individual risks as the current equity standards do.In this respect a recent simulation by Boyd-Graham (1988) provides useful empirical insights.Using American data,they show that activities such as securities and real estate increase the riskiness of banks while life insurance will stabilize it.Nevertheless,even if one wants to limit bank riskiness through limits on their powers,there is a second question of allowing or not holding company structures where banks are separated from the other affiliates ('corporate separateness'). As concerns holding companies ,two issues arise : there is the fear that the riskiness of the banking entity may increase while the second concerns the potential conflicts of interest between the holding company and its customers.

Riskiness could increase if a bank attempts to increase the

profit of the other affiliates at the expense of its own revenue through higher fees,sale of profitable assets or purchase of low quality assets,that is all actions that increase the potential liability of the lender of last resort.To avoid these potential transfers of profit and risks,one needs to control the financial transactions between affiliates.Such is currently the case in the United States.

Conflicts of interest could arise between the holding company and its customers.There is the conflict between the promotional role of the investment banker and the commercial bankers'obligations to provide disinterested services to savers.The security affiliate could be used to issue corporate bonds and repay unprofitable bank loans (Saunders,1977).These arguments have been used to separate the securities industry from banking in some countries.In other countries,the technique of 'corporate separateness' or 'Chinese Walls' has been recommended to avoid these conflicts.From a regulatory perspective ,it remains to be shown that private market mechanisms in 'universal banking' countries can limit these principal-agent conflicts through rating agencies or the value put on long term relationships, or if public regulation becomes necessary.

Conclusion

One way to realize the economic gains expected from European integration is to allow credit institutions to increase their

size and to engage in new activities.The European directives in the fields of banking and financial services delegate to national authorities the right to regulate the ownership of banks and their participations in non-financial firms.The regulation of banks is necessary to limit the exposure of lender of last resorts responsible for the stability of banking markets.However,this should not imply a complete separation between banking and commerce.Although the empirical studies on the gains to be expected from diversification are non-conclusive,it appears that holding company structure could be authorized.The potential liability of the lender of last resort would be limited as long as risk taking by banks can be monitored and the financial transactions between the banking entity and the other affiliates can be regulated.

An issue not discussed in this essay concerns competition and the need to monitor the eventual market power arising out of the bank-industry relationship.

	BELGIUM	DENMARK	FRANCE	GERMANY	GREECE	IRELAND	ITALY	LUXEMBOURG
No. Commercial Banks	86		367	252	33	42	200	122
No. Savings & mutual banks	31	219	624	598[a]	2	17	85	
No. Foreign Banks	61	5	131	148	19		38	102
No. Domestic Banks	56	214	860	702	16	59	247	20
Commercial Bank assets (ECU billion)	214		947.3	425	25	13.8	497	185
Other Depository Institutions assets (ECU billion)	29.6	75.2	329.2	585[b]	13.5	10	159	
GDP (ECU billion)	118.8	82.03	729.7	941.5	40.2	21	623.9	6.03
Total Assets/GDP	2.05	0.92	1.75	1.07	0.96	1.13	1.05	3.1
No. Inhabitants (millions)	9.9	5.1	55.4	61	9.9	3.5	57.2	0.37
Market Share of Five Largest Institutions	70%	78%	50%	44%	83%		55%	30%
ECU Rate (domestic currency per ECU)	43.2	7.8	6.9	2.07	148.5	0.77	1446	43.2

Table One : Summary statistics on selected banking systems, end of 1986.
Sources : OECD, The Banker, Hendrie (1988) and various national sources.
a - does not include 3,604 cooperative credit institutions
b - does include 3,604 cooperative credit institutions
c - includes deposits of Rabobank and Postbank
d - includes city and regional banks
e - includes 929 credit associations and credit cooperatives

	NETHERLANDS	PORTUGAL	SPAIN	UNITED KINGDOM	EEC	USA	JAPAN	SWITZERLAND
No. Commercial Banks	81	27	136	611	2176	14130	141[d]	233
No. Savings & Mutual Banks	67		213	140	1777	3563	1088[e]	215
No. Foreign Banks	40	9	36	300	-	459	64	109
No. Domestic Banks	108	18	313	451	3064	17234	1165	339
Commercial Bank assets (ECU billion)	255[c]	26.8	202	969	3835	2732	2616	465
Other Depository Institutions Assets (ECU billion)	15	13.6	108	194	1457	1234	2125	
GDP (ECU billion)	183.4	27.3	224.3	527.9	3526	3958	1947	148
Total Assets/GDP	1.47	1.48	1.38	2.2	1.5	1.0	2.4	3.1
No. Inhabitants	14.6	10.3	38.7	56.6	322	241.6	121.5	6.5
Market Share of Five Largest Institutions	84%	78%	46%	36%	13%	10%	20%	65%
ECU Rate (domestic currency per ECU)	2.34	156.3	141.7	0.72	-	1.07	170.2	1.73

Table One : Summary statistics on selected banking systems, end of 1986.
Sources : OECD, The Banker, Hendrie (1988) and various national sources.
a - does not include 3,604 cooperative credit institutions
b - does include 3,604 cooperative credit institutions
c - includes deposits of Rabobank and Postbank
d - includes city and regional banks
e - includes 929 credit associations and credit cooperatives

Table Two : Business included in the second directive

1.Deposit-taking and other forms of borrowing

2.Lending

3.Financial leasing

4.Money transmission services

5.Issuing and administering means of payments (credit cards,travellers cheques and bankers drqft)

6.Guarantees and commitments

7.Trading for own accounts or for the account of the customers in foreign exchange

8.Investment actiities (trading for own account or account of the customers)

a)Brokerage

b)Dealing as principal

c)Market making

d)Portfolio mamagement

e)Underwriting services

f)Professional investment advice

g)Safekeeping

9.Money broking

10.Credit reference services

11.Safe custody services

Table Three : Business included in the 'Investment Services' directive

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1.Brokerage

2.Securities dealing as principal;market making

3.Professional investment advice

4.Safekeeping and administration of financial instruments

5.Portfolio management

6.Money market instruments

7.Financial futures and options

8.Foreign exchange and interest rate instruments

9.Securities underwriting and related activities

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