



Universal Banking "American-Style"

Author(s): Charles W. Calomiris

Source: *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift für die gesamte Staatswissenschaft*, Vol. 154, No. 1, The New Institutional Economics Financial Institutions in Transition: Banks and Financial Markets (Mar. 1998), pp. 44-57

Published by: [Mohr Siebeck GmbH & Co. KG](#)

Stable URL: <http://www.jstor.org/stable/40752040>

Accessed: 28-02-2016 17:03 UTC

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <http://www.jstor.org/page/info/about/policies/terms.jsp>

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact support@jstor.org.



Mohr Siebeck GmbH & Co. KG is collaborating with JSTOR to digitize, preserve and extend access to *Journal of Institutional and Theoretical Economics (JITE) / Zeitschrift für die gesamte Staatswissenschaft*.

<http://www.jstor.org>

Universal Banking “American-Style”

by

CHARLES W. CALOMIRIS

American corporate banking has undergone enormous change over the past two decades. That change reflects a combination of long-run competitive pressures and short-run performance problems that led US banks and their regulators to a new American version of global universal banking. From the perspective of the scale and scope of banks, these changes represent a convergence of US banks to international norms in banking. At the same time, the US version of universal banking entails novel linkages between banks and financial markets in the pursuit of enhancing bank-customer relationships. These new linkages give universal banking a new complexity and richness which banks outside the US will increasingly imitate. (JEL: G21)

1. Introduction

The last decade has witnessed significant convergence in the practice and regulation of banking across countries, and the US has done more than its share of changing. Differences remain in structure, powers, and regulation across countries. Nevertheless, banking has become much more uniform internationally, and there is a good chance that current changes being contemplated in Europe, the US, Japan, and Latin America will reinforce the trend toward convergence.

More important than any single similarity in law, regulation, or practice is the common trend in banking “philosophy.” I will argue that global competition in financial services should be credited with producing regulatory, practical, and philosophical convergence, and with making bankers and regulators more willing to learn from each other’s experiences.

The US – uncharacteristically – has been a prime example of this convergence process. The US banking system began the 1980s as a longstanding exception to international norms. It consisted of many geographically isolated banks, with circumscribed activities, where bank relationships with corporate customers were limited by laws and regulations. By the middle of the 1990s, the US banking system had been transformed into one of large, nationwide banks offering a wide array of products in the context of rich, complex bank-client relationships. Many of the key elements of what made the American banking system unique prior to the 1980s – geographical fragmentation, a narrowly

Journal of Institutional and Theoretical Economics (*JITE*), Vol. 154 (1998)

© 1998 Mohr Siebeck – ISSN 0932-4569

defined range of services, and the seniority of bank claims on corporate clients – have now disappeared permanently.

The two essential dimensions of regulatory change in US banking during the 1980s and 1990s – deregulation of branching and consolidation, and expansion of bank powers – initially were viewed by regulators as largely independent sources of improving American banks' competitive position. Experience shows, however, that they are closely related, and that they have reinforced each other. Large nationwide banks are better able to serve as a platform for universal corporate banking (CALOMIRIS [1993], [1995], CALOMIRIS and RAMIREZ [1996]). Small banks have not been as successful in converting new bank powers – especially the abilities to underwrite securities and to invest in equity – into profitable corporate banking strategies.

In this paper, I trace the history of the past two decades of change in US corporate banking, and link it to changes in global competition, macroeconomic circumstances, and regulatory learning. I conclude with an appraisal of prospects for the future.

2. *The Philosophical Watershed*

The Old Philosophy (circa 1980). US banks make senior loans to customers, held on balance sheet, and these loans are financed by a captive market of bank deposits.

The New Philosophy. US banks must face global competition by providing a rich array of financial services, and by being willing to hold a variety of claims on their customers (senior debt, junior debt, equity, securitization backup, and swap counterparty positions), the scope of which is defined for each bank by the types of customers they wish to serve. Off-balance sheet financing (securitizations, loan sales, underwriting) is preferred in many cases to help expand the customer base the bank can serve with its capital.

Four dimensions of strategic change are most important: (1) cognizance of the need to compete within and across borders for business – with attendant emphasis on customer convenience and bank overhead costs in determining bank structure; (2) learning the value of a diverse product base and flexibility in the types of claims banks are willing to hold; (3) focus on using access to markets to lever the bank's capital, rather than seeing markets as competitors to banks; (4) focus on customers as defining the "niches" of products banks will choose to provide.

Much of the progress in US banking has been the child of bank adversity during the 1970s and 1980s. During the 1970s, high inflation and binding interest rate ceilings on bank deposits created strong incentives for depositors to find alternative investments, which set the stage for new forms of intermediation – commercial paper markets, finance companies, and mutual funds –

Table 1
Sources of On-Balance Sheet Debt Finance for US Banks

Bank Liabilities	Percentage Share of Total Financing				
	1950	1960	1970	1980	1989
Checkable deposits	69.8	60.0	39.0	26.1	21.0
Small time and savings deposits	26.7	34.9	38.5	37.7	44.8
Large time deposits	0.0	0.5	11.2	19.4	14.5
Other debt	3.5	4.6	11.2	16.8	19.6

Source: BAER and MOTE [1992].

resulting in a sharp contraction in banks' reliance on deposits (table 1). During the 1980s, declines in loan quality crippled many banks and created new opportunities for entry in the wake of bank disappearances or losses of bank capital. The loan losses began in the early 1980s in agricultural and oil-producing regions, but spread to money-center banks after the commercial real estate bust that followed the 1986 tax law changes. By the end of the 1980s many of America's largest banks were suffering unprecedented loan losses, and some were viewed as insolvent on a market value basis (table 2).

Table 2
Problem Real Estate Loans by Bank Size (Third Quarter of 1992)^a

Loan Category	Asset Size of Bank			
	Under \$100m	\$100m-\$1b	\$1b-\$10b	Over \$10b
All real estate loans	1.64	2.18	4.05	7.07
Construction	2.76	5.62	12.65	21.96
Commercial	2.10	3.01	5.33	10.84
1-4 Family	1.21	1.23	1.50	1.76

^a Percentage of loans overdue by more than 90 days, by type of loans.

Source: BOYD and GERTLER [1993].

Adversity taught banks about new sources of profit and new ways to lever their capital, and also brought new competitive pressure on banks, first from within the US and later from abroad. As in the 1920s, the distress of small banks during the early 1980s led to greater openness to branching and consolidation in traditionally unit banking states. Between 1979 and 1991, 39 states relaxed their branch banking laws.

As distress spread to large commercial banks, the need for entry and consolidation began to bring large foreign banks into the US. Foreign banks increased their share of domestic commercial and industrial loan holdings from 7% in 1983 to 14% by 1991, while US banks saw their share fall from 30% to 18% (table 3).

Table 3
 Percentage Shares of US Non-Farm, Non-Financial, Non-Mortgage,
 Business Debt Held

Year	US Bank C & I Loans	Foreign Bank C & I Loans	Finance Cos. C & I Loans	Bonds, CP, ABS	Government & Govt. Sponsored
1983	30	7	10	41	12
1986	26	10	10	47	10
1989	21	12	12	46	8
1991	18	14	12	44	7

Source: CALOMIRIS and CAREY [1994].

These influences combined to press US banks to cut their operational and financing costs, and to adopt a *narrower focus on customer niches, a broader focus on types of products and claims, and flexibility in finding ways of satisfying customers' needs*. Throughout this learning process, banks were pushed by new competition (both coming from within and outside the US), increased scarcity of capital, and threats to their pre-existing protected niches in the deposit and loan markets coming from new markets and types of intermediaries (money market mutual funds, commercial paper, and finance companies). Rather than surrender to the new competition from financial markets, banks found ways of becoming conduits to those markets for their customers, especially in securitizations and swaps. The result was a remarkable growth in US banks' income from fees (table 4).

Foreign entry into the US also had a silver lining. The loss of US market share within the US and abroad promoted the first attempts at deregulation in the areas of consolidation and powers during the late 1980s, as US regulators sought to ensure a continuing future for American banks (GREENSPAN [1988], [1990], [1992]).

Although banking distress can be credited with the relaxation of state branching laws, more fundamental long-run concerns shaped the Fed's policy both on bank consolidation and on bank powers. The Fed's support for expanding bank scale and scope explicitly reflected concerns that non-bank intermediaries and foreign banks were outcompeting American commercial banks, and that relaxation of regulation was necessary to give US banks a fighting chance to survive. Alan GREENSPAN [1988], [1990], [1992] has repeatedly argued that increased scale and scope in banking is essential to maintaining an internationally competitive US banking sector. For example, in a call for expanding bank powers, GREENSPAN [1988, 3f.] argued:

"The ability of banks to continue to hold their position by operating on the margins of customer services is limited. Existing constraints, in conjunction with the continued undermining of the bank franchise by the new technology, are likely to limit the future profitability of banking . . . If the aforementioned trends continue banking will contract either relatively or absolutely."

Table 4
Analysis of Sources of US Bank Income (all Insured Banks)

Year	ROE ^a	Net Interest Margin ^b	Non-Interest Income/Assets
1982	12.10	3.82	0.96
1983	11.24	3.78	1.03
1984	10.60	3.80	1.19
1985	11.32	3.93	1.32
1986	10.23	3.81	1.40
1987	1.29	3.91	1.43
1988	11.61	4.02	1.50
1989	7.33	3.99	1.62
1990	7.29	3.94	1.67
1991	7.71	4.10	1.79
1992	12.66	4.42	1.95
1993	15.34	4.42	2.13
1994	14.64	4.38	2.00
1995	14.71	4.31	2.02
1996	14.60	4.33	2.19

^a ROE is return on book equity.

^b Net Interest Margin is interest income less interest expense, divided by total earning assets.

Source: CALOMIRIS and KARCESKI [1997].

Similarly GREENSPAN [1990, 5] argued:

“In an environment of global competition, rapid financial innovation, and technological change, bankers understandably feel that the old portfolio and affiliate rules and the constraints on permissible activities of affiliates are no longer meaningful and likely to result in a shrinking banking system.”

Initial deregulation in the areas of consolidation and powers was followed by continuing deregulation, as regulators learned of the advantages (and the absence of costs) produced by relaxing barriers to bank consolidation and new activities. Individual state laws relaxing branching restrictions were followed by regional agreements among states, and culminated in the national branch banking law of 1994. During the 1980s, some bank performance differences related to branching were quite dramatic, and bank consolidation and efficiency gains followed quickly on the heels of regulatory changes (BERGER, KASHYAP and SCALISE [1995]). As table 5 shows, the performance of banks in branching states (such as North Carolina) was remarkably stable and profitable compared to that of banks operating in unit banking states (such as Illinois).

The deregulation of bank powers limitations also exhibited important learning effects on the part of regulators. Limited experimentation with relaxing Glass-Steagall limits on underwriting activities by bank holding company-owned underwriting affiliates began in 1987. At the same time, Edge Act banks

Table 5
Bank Performance in Illinois and North Carolina

Year	Number of Banks		Return on Assets (%)		Return on Equity (%)	
	IL	NC	IL	NC	IL	NC
1984	1240	63	-0.11	0.97	-1.76	16.47
1985	1233	63	0.63	0.98	9.55	16.82
1986	1218	65	0.71	1.07	10.70	18.22
1987	1209	68	-0.23	0.92	-3.88	15.38
1988	1149	71	0.99	1.06	15.66	16.86
1989	1119	78	0.88	0.97	13.53	15.62
1990	1087	78	0.68	0.85	10.05	13.77
1991	1061	81	0.67	0.74	9.40	10.99
1992	1006	78	0.72	1.03	9.32	15.24

Source: MCCOY, FRIEDER and HEDGES [1994].

operating abroad were involved in international underwritings under a much less restricted approach. The domestic underwritings of bank holding company affiliates were limited in size and were accompanied by more than 30 "firewalls" limiting connections among banks, bank affiliates, and underwriting clients, as well as special additional capital requirements for underwriting affiliates. Over time, the Fed raised the quantitative limits on private securities underwritings and lowered all of the special firewalls and capital requirements it had set for these underwriting affiliates. The Fed defended these actions before Congress in March 1997, arguing that experience indicated that these special rules limited bank synergies in universal banking and provided no real benefit. The Fed based its argument largely on a comparison of the domestic (highly regulated) underwriting affiliates (the so-called Section 20 affiliates) and the foreign (little-regulated) Edge Act underwriting affiliates of bank holding companies.

Just as important as regulatory learning, during the 1980s banks learned the value of new product lines, and found that it was possible to lever their capital resources by combining bank "relationship management" and monitoring with market sources of funding and risk management. Many of those important new activities entailed new involvement in the equity markets, and banks came to assume either a direct (ownership or underwriting) stake or an indirect (asset management) stake in these junior instruments.

Venture capital proved to be of extreme value during the capital crunch for several banks (Citicorp, Chemical, First Chicago, and most of all, Continental). The high profits and diversification potential of venture capital became especially clear during the hard times of the 1980s, when loan losses almost destroyed these banks. CALOMIRIS [1997] finds that for several US banks, profits on private equity investments produced more than 20% of their total net earnings during the 1980s, and tended to be uncorrelated or only weakly

positively correlated with earnings from elsewhere in the bank, thus producing significant diversification for the holding company. For these banks, the return on equity for private equity holdings was 21% for the 1980s and early 1990s.¹

Banks also learned to make the most of their capital resources by only using capital to absorb those risks which their role as intermediary required them to absorb (because of incentive constraints). The increasing use of syndications, loan sales, and securitizations – and the use of derivatives hedging to preserve capital – ushered in a new era of capital budgeting and risk management for US banks in which return on equity was no longer a simple multiple of return on assets, and in which risks were better taken into account and controlled by banks. The new emphasis on quantifying market and credit risk, deciding which risks to absorb and which to lay off, and the new focus on fee income (as opposed to interest income) all are the fruits of bank adversity during the 1980s.

Given that bank adversity lay at the heart of this new innovativeness, it should come as no surprise that one of the leaders in many of these developments was Continental Illinois, which went from an insolvent basket case, rescued by the government in 1984, to a premier wholesale relationship bank of the early 1990s (before it was acquired by the Bank of America at a hefty premium). After its demise and rescue by the government in 1984, Continental shed its retail operations and out-sourced its noncore functions to focus on its core competencies in corporate banking. The bank's niche was defined, not as a set of products per se, but rather as a set of employees (and hence a base of knowledge about certain types of customers) – a set of clients it wanted to have. Continental's internal training program emphasized overall profitability of client relationships, the sharing of information within and across "client teams" and "deal teams" within the bank, and the development of special internal accounting to allocate overhead costs and measure client profitability. Continental's strategy was to use new products as a way to lock in a "share of mind" – to move from simple to complex transactional services, and to provide financial and business advisory services as a means to achieve greater reliance on the bank by the client. By acquiring Continental and moving its headquarters of corporate banking to Chicago, Bank of America expressed its confidence in that approach.

The new emphasis on the economics of relationships, as opposed to productivity or profitability measured at the level of the product or service, is not unique to Continental. Chase's motto, "the right relationship is everything," bespeaks the same approach. Harris bank's "Vision 2002" is also based on a relationship-focused strategy, both in determining the combination of services, and the location of its branches (CALOMIRIS and KARCESKI [1994, 55–59], [1995, 14–26]. Similarly, BancOne's framework for profitability accounting places an emphasis on tracking overhead expenditure and evaluating the value of product

¹ Data reported in "Banks Putting Renewed Emphasis on Expanding Venture Operations," *Private Equity Analyst*, February, 1995, pp. 1, 10–12.

lines in light of overall client relationships (McCOY, FRIEDER and HEDGES [1994]). McCoy and his co-authors devote an entire chapter of their book to relationship banking ("The New Search for Growth: Relationship Banking"). In explaining the value of relationships, they explicitly point to the importance of quasi-rents resulting from search and switch costs, though they use a different language (p. 18):

"Capturing a greater share of existing customers' wallets through relationships has the potential of raising profitability significantly and locking in a bank's customer base. That is, if customers maintain several products and significant balances with a given bank, they will be less likely to switch to a competitor."

Bankers have come to believe that there are strong economies of scope in combining products within a single intermediary. These economies of scope do not take the form of physical production economies, but rather economies that arise in the context of relationship management. For example, there are marketing and sales cost economies from "cross-selling" – a lending relationship provides an opportunity to discuss additional products with a client. There are also information and monitoring cost economies of scope in relationships. A bank providing a loan or credit enhancement already tracks a firm's performance, and perhaps is enforcing a set of covenants or holding a collateral interest in the firm. It is consequently easier to evaluate and bear the counterparty risk of a swap with that customer, or easier to evaluate the customer's potential for a private or public equity offering.

Because these client economies of scope provide a competitive advantage on any single transactional dimension to intermediaries that already provide other transactional or advisory services to clients, and because such economies also imply costs of searching and switching on the part of clients, client economies of scope offer banks the opportunity to reap quasi-rents from their relationships. As RAJAN [1992] points out, however, such an ex-post competitive advantage need not translate into ex-ante economic profit. The competition for new relationships may guarantee that rents will be dissipated by front-loaded concessions to customers (so-called "loss leaders"). Indeed, underpricing loans as a means to attract customers into a relationship (sometimes referred to as "tying") has become a common practice. Bankers are trained not to judge profitability on the basis of individual transactions, but rather by evaluating the overall resources the bank devotes to a client (consisting predominantly of man-hours and funds) and the overall fees and interest paid by the client.

It is hard to find American bankers opposed to the new relationship banking strategy. The most prominent example of a contrarian was Bankers Trust, which long espoused a "transactional" vision of banking and which argued that relationship banking had been undermined by competition. That vision (which has now been supplanted by one of relationship banking at Bankers Trust) reflected a confusion between the old monopoly "rents" of the old world of

non-competitive banking and the new “quasi-rents” of the new world of universal banking. That confusion led Bankers Trust to discount the value of a client-based strategy and to see its business as a sequence of independent transactions. The enormous losses Bankers Trust suffered in 1994 and 1995 from its trading operations and its Latin American holdings suggests the risks a commercial bank faces when it ignores relationship banking. In contrast to Bankers Trust, Citibank’s and Bank of Boston’s successful strategies in Latin America were to establish large branching networks in several countries, and to pursue profitable consumer and small business relationships.

The importance of customer relationships and the quasi-rents they create has been widely documented in recent academic work. Over the past decade there has been an outpouring of empirical research documenting the special role of banks as information collectors and enforcers of contracts under asymmetric information (JAMES [1987]; JAMES and WIER [1988]; HOSHI, KASHYAP and SCHARFSTEIN [1990a], [1990b], [1991]; BOOTH [1992]; SLOVIN, SUSHKA and POLONCHEK [1993]; BEST and ZHANG [1993]; PETERSEN and RAJAN [1994]; BILLET, FLANNERY and GARFINKEL [1995]; KASHYAP and STEIN [1995]; and CALOMIRIS and WILSON [1997]).

Focusing on customer relationships also proves important in understanding the way new entry occurs into lending markets, and differences in the profitability of new and existing lenders. CALOMIRIS and CAREY [1994] point out that foreign bank entry into the US corporate lending market during the 1980s reflected a cost-of-funds advantage on the part of foreign banks during the US bank capital crunch. But foreign bank entrants suffered an information-cost disadvantage, which is visible in the form and pricing of foreign bank entry. Foreign banks were able to significantly underprice US banks only in the high-quality segment of the market. For high-risk customers (where information costs are more important) foreign bank pricing was similar to that of domestic banks. Compared to domestic banks, foreign banks were much more likely to lend in the low-risk segment of the market, and were much more likely to lend as passive members of syndicates or via the purchase of loans originated by domestic banks. The relationship-cost advantage of domestic banks is also visible in loan performance differences. NOLLE [1994] finds that foreign-owned banks in the US had much lower returns on assets in the 1990s, and that this differences reflects both higher overhead costs and higher loan-loss rates for foreign banks.

In their case analyses of nine bank mergers, CALOMIRIS and KARCESKI [1997] provide evidence that this new approach to client-based universal banking is central to understanding the merger wave of the 1990s in US banking and its potential efficiency gains. A bank’s mix of products and services, and its locational strategy, are set primarily by reference to the client base it is targeting rather than according to the technological costs or synergies associated with particular sets of products or services. Thus mergers and acquisitions must be seen in the context of client-based universal banking strategies.

3. American Universal Banking Remains American

As US banks have become larger, and increasingly have pursued new market-oriented activities – including underwriting, swap intermediation, securitization, venture capital finance, and asset management – their stakes in corporate clients have changed from almost exclusively senior debt claims to a mix of senior debt, junior debt and equity claims. Commensurately, their control over firms has been transformed from arms-length control – where banks are reliant on contractual covenants and collateral to bend clients to their will – to more direct control via their influence over firms as stockholders or as the agents of stockholders. In these senses, they have become much more like their banking colleagues in Europe and Japan.

Like continental universal bankers, American banks are now able to enjoy better control over their clients in some cases, and are able to reap economies of scope in information and control that come from long-term relationships and multiple products and services. US bank holding companies can now provide cradle to grave financing. Over a firm's life cycle, they can provide early-stage lending, private equity financing to help transform firms from private to public, underwriting for initial and subsequent equity offerings, and continuing control over firms via asset management.

At the same time, American universal banks have brought their history with them, and remain different from universal banks in other countries. Some of that history implies continuing limitations on what American universal banks can do. For example, limitations on acting as a broker and a dealer for the same security sale remains an important impediment in bank asset management for corporate pensions. Despite enormous progress in permitting banks to overcome broker-dealer limitations via the construction of "Chinese walls" that separate brokers and dealers working on the same transaction within the bank, ERISA (the Employee Retirement Income Security Act) laws still prevent asset managers within the bank holding company from purchasing unregistered foreign securities, or from purchasing in the primary market securities in which another affiliate of the bank is acting as lead underwriter.

On the positive side, however, one could argue that American banks are building a new, and perhaps better, form of universal banking – enjoying new technological economies of scope from combining traditional banking functions (gathering information about clients and controlling their behavior) with new opportunities to access the resources of American capital markets. Now freed from many limitations, American banks are finding ways to bring America's comparative advantage in capital markets into their banks. The limitations imposed on American financial development, which forced US banks to limit their size and scope unnaturally for over 100 years fostered the development of active, technologically dynamic securities markets. Now that US banks have been permitted to do more, they are finding that American financial markets offer an especially rich array of products and services for them to offer their

clients. Security market depth in primary markets and liquidity in secondary markets offer US banks underwriting, venture capital, securitization, derivatives, and asset management opportunities not enjoyed by banks in other countries.

4. *Unfinished Business*

It is possible to overstate the progress of universal banking in the US. In several areas where Congressional action is required to permit additional progress, Congress has expressed little interest in removing barriers.

Glass-Steagall limitations on private securities underwriting are a binding constraint for the largest American universal banks. Currently, banks must limit earnings from private securities offerings of Section 20 affiliates to 25% of the underwriting affiliate's revenue. Despite encouragement from Chairman Leach (of the House Banking Committee) and Secretary Rubin, it remains hard to predict whether progress can be made in further reducing barriers to underwriting for US banks.

Permitting the ownership of banks by non-bank firms remains a hotly contested issue. Proposals to reform CEBA (the Competitive Equality in Banking Act) laws to permit expanded activities by non-bank-owned banks have stalled. Congressional concerns over the concentration of power and possible conflicts of interest will not permit the chartering of non-bank-owned corporate banks. Even in the retail banking area, despite the obvious potential gains in technological improvement from allowing high-tech computing and telecommunications firms to enter consumer banking, there is little chance for immediate progress. Once high-tech non-banks (say, Microsoft or AT & T) enter banking – perhaps initially outside the US – it is possible that US legislators will react by allowing them to do so in the US, to preserve the competitiveness of America's banking system.

The asset management barriers imposed by ERISA seem another obvious area for relaxation. Pension funds managed by banks will increasingly suffer limitations on portfolio earnings and diversification as equity markets become global, and as US banks take a larger share of global underwriting. Emerging market securities offer unique portfolio opportunities to American investors, and banks often specialize in particular countries or industries whose risks may be unique. By limiting the purchase of non-US-registered securities, or those whose underwriting is managed by a bank affiliate, ERISA may force corporate pension clients to seek asset management services outside large US bank holding companies.

Safety net reform remains one of the key determinants of future progress in eliminating these and other barriers to universal banking. Many critics of further reform, including Congressmen, Senators, and even Chairman Greenspan, point to potential abuse of deposit insurance protection as a con-

cern when considering further regulatory relaxation. Bankers have been led to conclude that deposit insurance reform is the quid pro quo for further deregulation. The Bankers' Roundtable (a private association of America's largest banks) – perceiving that further relaxation of regulation will only follow the credible elimination of any potential taxpayer subsidization of bank risk-taking – proposed a bold plan in May 1997 for introducing market discipline into government deposit insurance.² Large US banks now are so convinced of the advantages of universal banking that they are doing their best to eliminate the "too-big-to-fail" doctrine. Despite some weaknesses, that plan provides cause to hope that American universal banks will continue down the path of expanded powers and modernization.

5. Conclusion

During the 1980s and early 1990s, America's banks did more than their share of "converging" as they came to learn the advantages of richer corporate banking relationships that have long characterized other countries. Now, it is the turn of other banking systems to learn from American banks. I believe foreign banks will imitate many of the recent innovations in American banking, and thus I see a new era of American-style universal banking dominating the financial services industry internationally over the next decade. Three observations underlie that prediction.

First, global competition in banking is here to stay because it is driven by new information and transaction technologies that regulators will not be able to tame. Already, competition is causing a re-organization of corporate lending. A fledgling bank loan sales market has just begun to operate in Europe. In explaining the rise of this market, bankers point to increasing pressures to conserve scarce bank capital and boost returns on equity.³ There may be some setbacks on the road to global banking deregulation, particularly in Europe where the short-run politics of European integration may favor some protection for existing inefficient European banks. Nevertheless, protectionism will likely disappear once it becomes clear that it undermines the global market share of the protected countries' banks.

Second, global competition outside of banks will encourage American-style changes within many countries' banking systems. Financial systems throughout the world are already seeing a new era of the securitization of risk (including Europe, Japan, Latin America, and developing countries in Asia). Their banks, like America's, will see increasing incentives to become conduits to financial markets rather than competitors with those markets. I predict that ten years

² See BANKERS ROUNDTABLE [1997].

³ Reported in "Europe's Banks Boost Plans for U.S.-Style Loans Market," *Financial Times*, July 28, 1997, p. 16.

from now, as banks and markets become more and more intertwined, very few academics will find it useful to divide the world into “bank-based” and “market-based” financial systems (a distinction which I think is of little use even today).

Third, the strategy of relationship banking (which underlies the American style of corporate banking) permits banks to operate more profitably. That economic logic will become inescapable in the new global environment where competition and securitization increasingly force banks to bend toward efficiency enhancement. Thus banks will be pushed more and more to pursue economics of scope. Those economies of scope reflect a combination of physical cost economies of distribution and clearing, informational cost economies of managing default risk (a risk common to lending, managing customers’ payment flows, and providing over-the-counter derivatives services), and relationship economies of marketing products.

References

- BAER, H. L. and L. MOTE [1992], “The United States Financial System,” Working paper, Federal Reserve Bank of Chicago.
- BANKERS ROUNDTABLE [1997], *Deposit Insurance Reform: Partnering for Financial Services Modernization*, The Bankers’ Roundtable: Washington, D.C.
- BERGER, A. N., A. KASHYAP and J. M. SCALISE [1995], “The Transformation of the U.S. Banking Industry: What a Long, Strange Trip it’s Been,” *Brookings Papers on Economic Activity*, 0(2), 55–218.
- BEST, R. and H. ZHANG [1993], “Alternative Information Sources and the Information Content of Bank Loans,” *Journal of Finance*, 48(4), 1507–1522.
- BILLET, M. T., M. J. FLANNERY and J. A. GARFINKEL [1995], “The Effect of Lender Identity on a Borrowing Firm’s Equity Return,” *Journal of Finance*, 50(2), 699–718.
- BOOTH, J. R. [1992], “Contract Costs, Bank Loans, and the Cross-Monitoring Hypothesis,” *Journal of Financial Economics*, 31(1), 25–41.
- BOYD, J. H. and M. GERTLER [1993], “U.S. Commercial Banking: Trends, Cycles, and Policy,” pp. 319–368 in: O. J. Blanchard and S. Fischer (eds.), *NBER Macroeconomics Annual 1993*, MIT Press: Cambridge, MA.
- CALOMIRIS, C. W. [1993], “Regulation, Industrial Structure, and Instability in U.S. Banking: An Historical Perspective,” pp. 19–115 in: M. Klausner and L. J. White (eds.), *Structural Change in Banking*, Business One-Irwin: Homewood, IL.
- [1995], “The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870–1914,” pp. 257–315 in: N. R. Lamoreaux and D. Raff (eds.), *Coordination and Information: Historical Perspectives on the Organization of Enterprise*, University of Chicago Press: Chicago.
- [1997], “The Contribution of Venture Capital to American Banks’ Profits,” Working paper, Graduate School of Business, Columbia University, New York.
- and M. S. CAREY [1994], “Loan Market Competition Between Foreign and U.S. Banks: Some Facts About Loans and Borrowers,” pp. 331–351 in: *Proceedings of the 30th Annual Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago: Chicago.
- and J. KARCESKI [1994], *Competing Bank Strategies in Chicago: An Illinois MBA Project Report*, The Office for Banking Research of the University of Illinois at Urbana-Champaign: Champaign, IL.

- and -- [1995], *The Bank Merger Wave of the 90s: Nine Case Studies*, The Office for Banking Research of the University of Illinois at Urbana-Champaign: Champaign, IL.
- and -- [1997], "Is the Bank Merger Wave of the 90s Efficient? Lessons From Nine Case Studies," forthcoming in: S. Kaplan (ed.), *Mergers and Productivity*, University of Chicago Press: Chicago.
- and C. D. RAMIREZ [1996], "The Role of Financial Relationships in the History of American Corporate Finance," *Journal of Applied Corporate Finance*, 9, 52-73.
- and B. WILSON [1997], "Bank Risk and Portfolio Management: The 1930s Capital Crunch and Scramble to Shed Risk," Working Paper, Graduate School of Business, Columbia University, New York.
- GREENSPAN, A. [1988], "An Overview of Financial Restructuring," pp. 1-9 in: *Proceedings of the 24th Annual Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago: Chicago.
- [1990], "Subsidies and Powers in Commercial Banking," pp. 1-8 in: *Proceedings of the 26th Annual Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago: Chicago.
- [1992], "Putting FDICIA in Perspective," pp. 1-7 in: *Proceedings of the 28th Annual Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago: Chicago.
- HOSHI, T., A. KASHYAP and D. SCHARFSTEIN [1990 a], "The Role of Banks in Reducing the Costs of Financial Distress in Japan," *Journal of Financial Economics*, 27(1), 67-88.
- , -- and -- [1990 b], "Bank Monitoring and Investment: Evidence From the Changing Structure of Japanese Corporate Banking Relationships," pp. 105-126 in: R. G. Hubbard (ed.), *Asymmetric Information, Corporate Finance, and Investment*, University of Chicago Press: Chicago.
- , -- and -- [1991], "Corporate Structure, Liquidity, and Investment: Evidence From Japanese Industrial Groups," *Quarterly Journal of Economics*, 106(1), 33-60.
- JAMES, C. [1987], "Some Evidence on the Uniqueness of Bank Loans," *Journal of Financial Economics*, 19(2), 217-235.
- and P. WIER [1988], "Are Bank Loans Different? Evidence From the Stock Market," *Journal of Applied Corporate Finance*, 1, 46-54.
- KASHYAP, A. and J. C. STEIN [1995], "The Impact of Monetary Policy on Bank Balance Sheets," *Carnegie Rochester Conference Series on Public Policy*, 42(0), 151-195.
- MCCOY, J. B., L. FRIEDER and R. HEDGES [1994], *Bottom Line Banking: Meeting the Challenges for Survival and Success*, Probus: Chicago.
- NOLLE, D. E. [1994], "Are Foreign Banks Out-Competing U.S. Banks in the U.S. Market?" Working paper, Office of the Comptroller of the Currency, Washington, DC.
- PETERSEN, M. A. and R. G. RAJAN [1994], "The Benefits of Lending Relationships: Evidence From Small Business Data," *Journal of Finance*, 49(1), 3-37.
- RAJAN, R. G. [1992], "Insiders and Outsiders: The Choice Between Informed and Arms-Length Debt," *Journal of Finance*, 47(4), 1367-1400.
- SLOVIN, M. B., M. E. SUSHKA and J. A. POLONCHEK [1993], "The Value of Bank Durability: Borrowers as Stakeholders," *Journal of Finance*, 48(1), 247-266.

Professor Charles W. Calomiris
 Graduate School of Business
 Columbia University
 418 A Uris Hall
 3022 Broadway
 New York, NY 10027
 U.S.A.