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Universal Banking and Financial Stability

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UNIVERSAL BANKING AND FINANCIAL STABILITY

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Is universal banking a solution to the problem of bank failure? Many critics of the United States' fragmented banking structure believe so. The United States Treasury Department based its recommendation to allow banks to affiliate with financial and commercial firms on the assumption that "the blending of banking, finance and commerce will create a stronger, more diversified financial system."[1] Bank regulators in France, Germany and Italy cite universal banking as an explanation of their nations' low rates of bank failure compared with that of the United States.[2]

As the cost of bank failure continues to mount, this argument for universal banking becomes especially compelling. If bank failure rates are an appropriate yardstick of financial stability, the European-style universal banking model has proved to be much more stable than our own unique fragmented financial structure.[3]

Nevertheless, two questions remain unanswered. First, why are universal banks apparently less prone to failure than fragmented banks? Second, if universal banking becomes the domi-

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1. MODERNIZING THE FINANCIAL SYSTEM: U.S. TREASURY DEPARTMENT RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 55 (1991) [hereinafter TREASURY RECOMMENDATIONS].

2. *See* General Accounting Office, *Deposit Insurance: Overview of Six Foreign Systems*, GAO/NSIAD-91-104 31 (1991) [hereinafter *GAO Study*] ("In the opinion of their national regulators, French, German and Italian banks that operate as universal banks are able to lessen their risk of exposure through their ability to offer diversified services.").

3. Germany, France and Italy are usually viewed as the nations with the purest universal banking systems. Japan retains legal barriers between commercial and investment banking (which date from the post-war occupation and were based on our own Glass-Steagall Act), but, in practice, the network of financial relationships within the bank-centered corporate groups known as *keiretsu* has produced a banking system that is closer to the universal banking model than to the U.S. model. Britain has been moving toward universal banking, although commercial and investment banking historically have been dominated by separate entities; in fact, the British system is generally thought to be the model for our fragmented regulatory structure. *See* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 485-86 (1971). As will be shown, however, U.S. financial markets and financial market regulation have been shaped by uniquely American experiences and differ from both their British and continental European counterparts.

nant financial structure in the United States, will United States banks enjoy the same stability as their European rivals?

The answers to these questions may be somewhat surprising. A close analysis of universal banking systems reveals that their source of strength is not the combination of different financial services under one roof, but a peculiar capital market structure that has necessitated the forging of defensive long-term bank-client relationships. Moreover, other factors, including oligopolistic industry structures and government policy, have contributed more to keeping banks healthy than has the mix of bank powers. This suggests that European-style universal banking (or its Japanese variation) is indigenous. Attempts to transplant it to the United States will produce an entirely different hybrid.

This does not mean that the United States should not expand the legal powers of its banks. It simply means that attempts to replicate the universal banking model, particularly in the hope of finding a solution to current banking problems, are likely to fail. Universal banking, American-style, will assume a form uniquely suited to our own fragmented, highly competitive and potentially unstable financial markets.

I. UNIVERSAL BANKING AND DIVERSIFICATION

German banks are permitted by law to offer a full range of commercial banking (lending) and investment banking (underwriting and dealing) services.[4] British deposit-taking banks engage in merchant banking, usually through subsidiaries.[5] Until recently, Japanese banks were barred from underwriting,[6] but they have traditionally provided other securities-related services and have even acted as advisers and agents for securities issuers.[7] In both Europe and Japan, the trend is toward broadening banking powers. Japanese banks are gradually gaining entry into the underwriting business.[8] European banks are moving into

4. For a brief description of relevant German, United Kingdom and Japanese laws, see Alan J. Daskin & Jeffrey C. Marquardt, *The Separation of Banking from Commerce and the Securities Business in the United Kingdom, West Germany and Japan*, 7 ISSUES IN BANK REG. 18 (1983).

5. *Id.* at 17.

6. *Id.* at 20.

7. *Id. See also* David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 381 (1990).

8. *See* James Sterngold, *A Japanese-Style 'Old Boy' Network*, N.Y. TIMES, June 7,

insurance.[9]

Economic theory suggests that diversification can limit risk.[10] In view of the decline of the traditional corporate lending business in the United States,[11] diversification might allow banks to tap new profit sources. This theory supports the proposition that universal banks are more likely than fragmented banks to be able to weather financial distress. So why not follow the European example and allow United States banks to diversify into financial or even non-financial businesses?

One response is that, as a practical matter, American banks already have many of the powers of universal banks. In Europe, United States bank affiliates participate actively in the securities markets.[12] In the United States, bank affiliates may engage in limited amounts of corporate securities underwriting, including underwriting equity offerings.[13] In the first half of 1992, J.P. Morgan & Co. (the commercial banking firm, not to be confused with the investment banking firm of Morgan Stanley) was lead or co-manager of 2.8 billion dollars of public stock offerings[14] — a substantial accomplishment for a banking company that first received regulatory approval to underwrite equity in September 1990.[15]

1991, at A1, D6.

9. *E.g.*, Friedrich K. Kübler, *Institutional Owners and Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97, 99 n.17 (1991).

10. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 136 (4th ed. 1991).

11. This decline is dramatically illustrated by recent lending statistics. As of June 30, 1992, holdings of government securities by U.S. banks exceeded holdings of commercial and industrial loans for the first time in 27 years. William Goodwin, *Business Loans Eclipsed By U.S. Bond Holdings*, AM. BANKER, July 27, 1992, at 1. Commercial lending is now one of the most foreign-dominated U.S. business sectors, surpassing even automobiles and chemicals. James R. Kraus, *Foreign Banks Control 45% of Corporate Loans in U.S.*, AM. BANKER, June 15, 1992, at 1.

12. *See* 12 C.F.R. § 211.5(d)(13) & (14) (1992) (permitting U.S. bank affiliates to underwrite and deal in securities outside of the U.S.). Although equity underwriting and dealing are subject to volume limitations (in the case of equity underwriting, $60 million or 25% of Tier I capital per issuer), the regulations permit unlimited underwriting and dealing in debt securities outside of the United States. *See* 12 C.F.R. § 211.5(d)(13) & (14)(ii).

13. *J.P. Morgan & Co. Inc., The Chase Manhattan Corp., Bankers Trust N.Y. Corp., Citicorp and Security Pacific Corp.*, 75 FED. RESERVE BULL. 192, 193 (1989) [hereinafter *J.P. Morgan et al.*].

14. Kelley Holland, *Dual Roles: Morgan Walks a Fine Line*, AM. BANKER, July 1, 1992, at 10.

15. *See* Keith R. Fisher, *Reweaving the Safety Net: Bank Diversification Into Securities and Insurance Activities*, 27 WAKE FOREST L. REV. 123, 158 & n.165 (1992).

Of course, Morgan is a strong bank. Many weaker banks cannot take advantage of securities powers, in part because regulatory costs remain high. Banking organizations must receive prior regulatory approval to set up securities affiliates in the United States.[16] Domestic securities affiliates are subject to complex operating conditions designed to ensure compliance with existing laws and to address the potential for conflicts of interest.[17] Were these regulatory costs to be reduced, would more banks be able to diversify and, more importantly, take advantage of the risk-reducing effects of diversification?

The answer is no, as the experience of successful universal banks in both Germany and the United States demonstrates. First, diversification theory has proved unworkable in practice because most business firms diversify very poorly. Second, successful universal banks are not really diversified at all. The key to universal banking is cross-marketing, which means selling *more* services to *fewer* customers. Broader product diversification is offset by exposure to a narrower client base. Ironically, the typical United States commercial bank is actually more diversified than its European counterpart. That may be its problem.

A. *Portfolio Theory: How Banks Are Taught to Diversify*

Portfolio theory teaches that investors can reduce exposure to firm-specific risk by buying securities whose returns are negatively correlated.[18] This theory is used to support the argument that universal banks are less risky than fragmented banks. By diversifying their product mix, the story goes, universal banks reduce their exposure to the highly cyclical commercial lending business.

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16. Individual applications must be made to the Federal Reserve Board under section 4(c)(8) of the Bank Holding Company Act of 1956, 12 U.S.C. § 1843(c)(8) (1988). The Board has stated that it will scrutinize each applicant's internal risk management controls and operational and managerial infrastructure before granting underwriting powers. *See J.P. Morgan et al., supra* note 13, at 217.

17. These so-called "firewalls" include revenue limitations on underwriting and dealing in corporate securities (to comply with the Glass-Steagall Act's ban on affiliations between banks and companies "engaged principally" in investment banking, 12 U.S.C. § 377 (1988)), and various regulatory restrictions on joint marketing and funding of commercial and investment banking operations. For a list of the original 18 firewalls, some of which have been or are in the process of being modified by the Federal Reserve Board, see *J.P. Morgan et al., supra* note 13, at 214-17.

18. *See* Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

Corporate line-of-business diversification, however, has never been shown to have the same risk-reducing effect as portfolio diversification by securities investors. One reason is that corporate diversification is costly. Starting a new line of business requires substantial commitments of capital, expertise and time. In the financial services industry, where reputation is key, entry into new product markets is particularly difficult, as suggested by the experience of several banks that, having quickly set up securities affiliates when legal interpretations of the Glass-Steagall Act permitted limited amounts of underwriting,[19] closed them just as quickly when earnings failed to justify expenses.[20] Alternatively, banks can diversify by acquiring established businesses, but they often wind up paying substantial premiums to existing owners[21] and incurring unanticipated integration costs, including the cost of shedding unwanted operations.[22]

It is doubtful that these costs are outweighed by the risk-reducing benefits of line-of-business diversification. This proposition is hard to test,[23] but it is noteworthy that securities investors apparently do not place a premium on corporate diversification. To the contrary, in the 1970s and 1980s, investors tended to discount the stock of diversified conglomerates, re-

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19. *See* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47 (2d Cir.), *cert. denied*, 486 U.S. 1059 (1988) (interpreting Glass-Steagall provisions forbidding affiliations between banks and firms "engaged principally" in securities underwriting and dealing); *see also supra* text accompanying note 13.

20. *E.g.*, Tom Leander, *Bank of Boston Closes Sec. 20 Unit*, AM. BANKER, June 5, 1990, at 2.

21. This was the experience in the early 1980s of banks that, looking to gain quick entry into the then lucrative discount brokerage business, paid huge premiums for successful franchises. Within six years, the discount brokerage business had lost its luster and banks were forced to scale back their brokerage operations. *See* Jed Horowitz, *Chase May Sell Discount Brokerage Subsidiary*, AM. BANKER, Nov. 8, 1988, at 3; *see also* J. Nellie Liang & Donald T. Savage, *The Nonbank Activities of Bank Holding Companies*, 76 FED. RESERVE BULL. 280, 288 (1990) (Federal Reserve study of non-bank subsidiaries of bank holding companies from 1986-1988 found discount brokerage to have been the least profitable non-banking activity during this period).

22. These costs are discussed more fully in Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 338-41 (1990).

23. One problem is that some diversification costs, such as integration costs, are not immediately apparent. Corporate experts estimate that the success or failure of an acquisition cannot be measured for at least two years. John Kitching, *Why Do Mergers Miscarry?*, HARV. BUS. REV., Nov.-Dec. 1967, at 85. Banking experts have asserted that, in bank mergers, it takes an average of *22 years* for the buyer finally to realize its targeted return on investment. Joseph F. Sanchez, *Comment/Mergers: Workout Time Proves Key Measure*, AM. BANKER, Nov. 14, 1990, at 18.

flecting their own superior ability to diversify their stock portfolios[24] and their lack of confidence in the efficiency of the conglomerate structure.[25] The response of the non-banking sector (and some banks) was to shed operations and move toward greater specialization.[26] Although this evidence is anecdotal, it does raise questions about the efficiency of diversification as a corporate strategy.[27]

In any event, the risk-reducing benefits of diversification are achievable only if the firm combines businesses whose returns are negatively correlated.[28] Is this true of the kinds of financial services that are offered by a universal bank? Advocates of bank securities activities in the 1920s assumed so. One banker wrote in 1929:

> In periods when interest rates are low the commercial banking business has its profit margin cut very drastically. At these times the public is usually absorbing . . . a large amount of investment securities . . . . If the security affiliate of the bank does a business of sufficient volume then its earnings will act as an offset to the lowered profits of the commercial end.[29]

Is this assumption accurate? Empirical testing has been difficult, since, until recently, banks did not engage extensively in securities operations.[30] Nevertheless, at least one study that compared the performance of separate banking and securities firms found a *positive* correlation between returns on commer-

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24. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 33 n.88 (1986) (citing studies concluding that shareholder diversification is more efficient than conglomerate diversification). Even small savers can achieve portfolio diversification by investing in a diversified mutual fund.

25. Investors apparently did not share the view of many economists that the superior monitoring ability of the conglomerate should (at least in theory) be value-enhancing. *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 148 (1975).

26. For an analysis of this "deconglomeration" movement, see Coffee, *supra* note 24, at 52-60.

27. This skepticism about the benefits of corporate diversification is shared by many corporate governance experts. *See, e.g.*, BREALEY & MYERS, *supra* note 10, at 728-30; Coffee, *supra* note 24, at 31-35.

28. *See supra* note 18 and accompanying text. Simply put, the goal is to reduce unique, or firm-specific, risk. If, at any given time, poor returns on one investment are offset by high returns on other investments, total earnings variability is reduced.

29. J. Harvie Wilkinson, Jr., *Bank Security Companies*, 119 BANKERS MAG. 927, 928 (1929).

30. For a discussion of some of the problems with past empirical studies of bank diversification, see Garten, *supra* note 22, at 330-32.

cial and investment banking.[31] (Analysis of investment portfolios containing bank and securities company *stocks* may produce a different result, but this analysis does not measure the effect of combining lines of business.[32])

Moreover, financial markets have changed dramatically since 1929. The high-grade corporate lending business has not just suffered a cyclical downturn. It has all but disappeared. As short-term debt markets expanded, commercial firms no longer faced a choice between short-term bank financing and long-term securities financing. Barring a major market disruption, highly rated firms can always borrow more cheaply in the debt markets than from banks. Commercial paper issues by non-financial firms rose from ten percent of all short-term business borrowing in the mid-1970s to twenty percent by the early 1980s.[33] Business lending by the ten largest United States banks has steadily declined since 1983.[34]

This suggests that, for many banks, the securities business is less an adjunct than an alternative to traditional corporate lending. Moreover, what lending business remains is often linked to the securities markets. For example, a major portion of a bank's current lending business may consist of issuing back-up

31. *See* Roger D. Stover, *A Re-Examination of Bank Holding Company Acquisitions*, 13 J. BANK RES., Summer 1982, at 101, 105. Of course, this is just one study. Subsequent researchers may quarrel with its methodology and results; in fact, the Stover study was an attempt to correct methodological problems identified in prior studies. This illustrates another problem with past empirical testing of bank diversification. Since researchers still disagree over how best to measure the risk-reducing effects of corporate diversification, definitive conclusions based on empirical data are elusive.

32. *See* Garten, *supra* note 22, at 317. A problem with applying the lessons of portfolio diversification to line-of-business diversification is that, unlike securities investors, business firms do not necessarily treat each line of business as a separate (and passive) investment. Banking companies in particular have tended to integrate the administration, funding and marketing of separate product lines. As a result, the fortunes of different businesses become intertwined. *See* Garten, *supra* note 22, at 366-67. This may explain why studies of real bank holding companies have found that the profit rates of bank and non-bank subsidiaries have actually moved in tandem. *See* Liang & Savage, *supra* note 21, at 287; *see also infra* note 63.

33. Timothy D. Rowe, *Commercial Paper*, *in* FEDERAL RESERVE BANK OF RICHMOND, INSTRUMENTS OF THE MONEY MARKET 121 (Timothy Q. Cook & Timothy D. Rowe eds., 1986). Despite some recent credit quality problems, the commercial paper market remains active (estimated at $740 billion as of 1991) and an efficient source of funds for highly rated borrowers — once the banks' most reliable and lucrative customers. Jonathan Fuerbringer, *Commercial Paper Has Troubles, Too*, N.Y. TIMES, Feb. 10, 1991, § 3, at 4.

34. *See* Table: *Business Lending by Banks in the U.S.*, AM. BANKER, June 18, 1992, at 10.

lines of credit to support customers' commercial paper or short-term debt programs.[35] The same bank may act as agent in placing corporate debt securities with investors (although, under current regulatory interpretations, the bank may not perform both services in connection with the same debt issuance.[36]) This means that when market conditions are favorable for debt issuances, the diversified bank earns both securities placement fees and commitment fees for back-up credit.

When market conditions are unfavorable, debt issuers may draw on their back-up lines of credit, but this is not necessarily good news for the bank despite the promise of interest income. Unlike unused lines of credit, loans have to be funded. If the bank's own funding costs are high, as is true today for many banks, interest margins will be thin. Moreover, if the issuer cannot sell debt because of a ratings downgrade or other adverse financial development, the lending bank will be taking a significant credit risk. Interest earnings may not compensate for lost securities-related income.

In any case, United States banks that have entered the securities business have not followed a diversification strategy aimed at achieving "balanced earning power."[37] Instead, they have become highly specialized, eschewing broad diversification in order to dominate particular product markets. As will be shown, European-style universal banks have followed the same path.

B. How Successful Universal Banks Diversify

Although the United States may be alone in mandating financial specialization as a matter of law, even universal banking systems exhibit considerable de facto specialization. In Germany, for example, all banks have universal banking powers, but only a handful of the over 4000 German banks actually underwrite securities.[38] The banking industry is divided into three

35. As of the second quarter of 1990, $743 billion of these unused credit commitments were outstanding. Steven Lipin, *Unused Credits Of $743 Billion Seen As Stimulus*, AM. BANKER, Nov. 30, 1990, at 1.

36. *See J.P. Morgan et al.*, *supra* note 13, at 214 (forbidding banks to issue letters of credit enhancing creditworthiness of securities underwritten or distributed by their securities affiliates); *but see J.P. Morgan & Company Inc.*, 76 FED. RESERVE BULL. 26, 27-28 (1990) (permitting extensions of credit to underwriting customers where proceeds are used to pay off the debt at maturity).

37. Wilkinson, *supra* note 29, at 928.

38. Herman H. Kallfass, *The American Corporation and the Institutional Investor:*

main segments: the public sector banks, which act as savings banks; the cooperative banks; and the private (commercial) banks.[39] Underwriting syndicates are dominated by the "Big Three" private banks: Deutsche, Dresdner and Commerzbank.[40] German banks also participate in the industrial sector by exercising voting rights on behalf of individual shareholders in German corporations.[41] Again, the Big Three dominate. As of the end of 1984, they controlled the voting rights of approximately forty-three percent of all investment portfolios.[42]

Japan has an even more complex pyramidal banking structure which includes, from bottom to top, small credit associations and cooperatives (numbering in the thousands), *shinkin* (retail and small business lenders), *sogo* (originally, savings banks), regional banks, and the giant city, long-term and trust banks.[43] (Recently, however, Japan's fragmented banking markets have been merging as a result of the decline of the traditional corporate lending business. As their borrowers have defected to the securities markets, the largest banks have invaded the local lending markets traditionally served by *shinkin*.[44]) The Japanese *keiretsu*, or bank-dominated corporate groupings, are responsible for further market fragmentation, allowing business firms to rely on their group bank for most of their financial needs.[45]

Thus, the German and Japanese banking markets are highly segmented, with different banks serving different economic sectors (e.g., large corporations, small businesses, individual borrowers) and different clients within each sector. German private banks have stable, long-term relationships with corporate customers that tend to obtain most or all of their financial services

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Are There Lessons From Abroad? The German Experience, 1988 COLUM. BUS. L. REV. 775, 779.

39. *GAO Study*, *supra* note 2, at 14.

40. Kallfass, *supra* note 38, at 779. As of December 31, 1991, based on total assets, Bayerische Vereinsbank narrowly outranked Commerzbank as the third largest German banking institution. Deutsche and Dresdner remained first and second, respectively. *See* Table: *Top 500 Banks by Country*, AM. BANKER, July 27, 1992, at 26A.

41. Kallfass, *supra* note 38, at 782.

42. Kallfass, *supra* note 38, at 783.

43. Henny Sender, *Japan's not-so-mighty banks*, INSTITUTIONAL INVESTOR, Nov. 1990, at 130.

44. *Id.* at 131-32.

45. For a description of the *keiretsu*, see Marie Anchordoguy, *A Brief History of Japan's Keiretsu*, HARV. BUS. REV., July-Aug. 1990, at 58.

from their banks.[46] Japanese *keiretsu* banks traditionally have enjoyed similar relationships with group members.[47]

Product markets are also segmented. German universal banks have the power to offer any kind of investment or commercial banking product, but the range of services that is actually available is narrow by American standards. For example, German banks have not entered the lucrative field of merger and acquisition advice — a growth area for United States banks in the 1980s — because, in Germany, hostile takeovers have been virtually unknown.[48] German banks have also been slow to offer their corporate clients sophisticated financial products such as derivatives, swaps, futures and options.[49] With the exception of Deutsche Bank, German banks have not participated extensively in the Eurobond market or in other international securities markets.[50]

Instead, German banks have concentrated on providing traditional capital market services, mainly loans and securities placement, in domestic markets. The extent of this de facto specialization is illustrated by recent attempts by German banks to position themselves to compete more effectively in integrated European markets. For example, Deutsche Bank, called by one observer "the most universal of all universal banks,"[51] had to acquire Morgan Grenfell & Co., a London merchant bank, to gain instant expertise in merger advice and investment

46. Kübler, *supra* note 9, at 103 (describing this "Hausbank" function). At least for large German firms, credit relationships may not be exclusive. Publicly held firms may maintain multiple main-bank relationships (reflecting their demand for capital). *See* Theodor Baums, *Corporate Governance in Germany: The Role of the Banks*, 40 AM. J. COMP. L. 503, 508 (1992). Nevertheless, these firms' reliance on banks for securities underwriting (and these same banks' control of voting power) suggest the logic of stable, long-term banking relationships. For further discussion, see *infra* text accompanying notes 72-96.

47. In Japan, this may be changing as the largest corporations are forced to look beyond their *keiretsu* banks for financing, thereby breaking established banking-corporate ties. For further discussion of the implications of this change for Japanese banking, see *infra* text accompanying notes 87-95.

48. Kübler, *supra* note 9, at 102. One reason for the absence of a takeover market may be the concentration of corporate ownership and voting power in the hands of banks and other corporations. *See infra* text accompanying notes 102-04.

49. James R. Kraus, *Solid German Banks May See Profit Slump in '92*, AM. BANKER, July 27, 1992, at 8A-9A.

50. *Id.* at 9A.

51. Anthony D. Loehnis, *EC on Its Way to Integrating Markets*, AM. BANKER, Dec. 16, 1991, at 1A, 3A.

management.[52]

This evidence suggests that the typical diversification strategy of the German universal bank has been the joint marketing of a limited number of financial products (typically lending and securities placement) to a stable group of corporate clients. This strategy has been followed by American banks that have successfully entered the securities business. The key to successful universal banking, American-style, is to offer *more* services to *fewer* customers — a strategy that worked well for the old House of Morgan and other private banks that operated in pre-Glass-Steagall banking markets. The House of Morgan provided "cradle to grave" financial services to long-term corporate clients,[53] including lending, underwriting, providing financial advice and voting proxies on behalf of public shareholders.[54] The House of Morgan was not a "full service" bank. It did not hold a diversified lending portfolio. It did not offer an array of financial products to the public. It did not maintain any presence in retail or even small business markets.[55]

Modern-day approaches to diversification are remarkably similar. Today's J.P. Morgan (successor to the old House of Morgan's banking business)[56] has been successful in marketing a combination of wholesale financial products, typically credit lines, underwriting and financial products, to long-time Morgan clients such as General Motors and Hospital Corporation of America.[57] Some observers have suggested that Morgan's success reflects its ability to build on corporate lending relationships to cross-market securities services.[58] For example, when Security Pacific was unable to roll over five billion dollars of its commer-

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52. *Id.*

53. Actually, "grave to cradle" may be more accurate, since many Morgan clients, including General Electric and New York Central, were products of reorganizations of troubled companies engineered by Morgan. *See* RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 66-67 (1990).

54. One critic characterized these stable bank-client relationships as putting the bank at the center of a "web of economic interests." A. A. Berle, Jr., *Non-Voting Stock and "Bankers' Control"*, 39 HARV. L. REV. 673, 676 (1926).

55. *See* JOSEPH AUERBACH & SAMUEL L. HAYES, III, INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION? 13 (1986).

56. The Glass-Steagall Act, adopted in 1933, forced Morgan and other universal banks to choose between commercial and investment banking. Morgan chose commercial banking. The new firm of Morgan Stanley was formed to take over the bank's securities business. *See* CHERNOW, *supra* note 53, at 385-91.

57. Holland, *supra* note 14, at 1.

58. Of course, the actual tying of banking and securities products is illegal under the Bank Holding Company Act, 12 U.S.C. § 1972 (1988).

cial paper, Morgan put together a bank syndicate to provide a one billion dollar emergency line of credit. Morgan was then named agent on Security Pacific's medium-term note program. As one banker commented: "When Morgan comes to the rescue [with credit], they have quite a nice call on a firm after that."[59]

Thus, Morgan's strategy is to sell a package of related capital market services to large corporate clients. Ironically, as the corporate lending business shrinks, wholesale banks like Morgan may become even more specialized, offering only securities-related products. One universal-style United States bank that has already moved in this direction is Bankers Trust, which has not operated a retail branch since 1982.[60] Bankers Trust has concentrated on developing a package of sophisticated investment products, such as index funds for institutional investors, derivatives and foreign currency trading, designed primarily for the wholesale market. Although the bank is now seeking to expand its customer base by offering proprietary mutual funds through other financial institutions, this move simply builds on existing expertise in investment services.[61] The strategy is specialization, not diversification.

C. *How United States Commercial Banks Have Diversified*

Compared with German banks (and United States wholesale banks like Morgan and Bankers Trust), most United States commercial banks are already highly diversified. Within the existing legal framework (and even before recent legal interpretations permitting bank securities activities), banks have been able to achieve extensive *product* diversification, combining services such as corporate and consumer lending, home and commercial mortgages, trust banking, stock transfers, leasing and data processing, *market* diversification, serving both retail and business customers, and even *geographical* diversification.[62] Empirical studies have found that the returns on some of these businesses, notably commercial finance and home mortgage lending, may be negatively correlated with returns on commercial lend-

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59. Holland, *supra* note 14, at 10.

60. Ellen Braitman, *Bankers Trust Seeking Approval to Expand Mutual Fund Business*, AM. BANKER, June 18, 1992, at 1.

61. *See id.* at 12.

62. Despite restrictions on interstate branching, banks have found ways to collect deposits and make loans in national markets. *See* H. Rodgin Cohen, *Interstate Banking: Myth and Reality*, 18 LOY. L.A. L. REV. 965 (1985).

ing, providing diversification potential.[63]

Nevertheless, in recent decades, many banks have come to view diversification as a curse rather than a blessing. The Penn Square-Continental fiasco highlighted the dangers of lending outside of a bank's home base without local expertise.[64] Poor bank performance in ancillary businesses such as consumer finance and mortgage banking compared with independent rivals[65] has encouraged diversified banks to shrink.[66] Unsuccessful attempts by diversified non-bank financial institutions such as Prudential-Bache to be all things to all customers provide a cautionary tale for banks.[67] Today, specialization and outsourcing have replaced the construction of financial supermarkets as preferred management strategies.

This does not mean that diversification cannot work. Perhaps United States banks diversified too much rather than choosing new businesses on the basis of their contribution to an efficient portfolio.[68] Alternatively, bank managers may simply

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63. *E.g.*, Stover, *supra* note 31, at 105. Likewise, intercorrelations among different non-banking businesses offer additional diversification potential for the bank that combines commercial banking with several non-banking activities. Stover, *supra* note 31, at 106. Nevertheless, a Federal Reserve study of actual non-bank subsidiaries of bank holding companies between 1986 and 1988 found that, although commercial finance and mortgage banking were (along with securities brokerage) the most significant non-banking activities for diversified bank holding companies, aggregate yearly profit rates for bank and non-bank subsidiaries actually moved in tandem, raising questions about the potential gains from diversification. *See* Liang & Savage, *supra* note 21, at 287; *see also supra* note 32.

64. As part of an effort to diversify its loan portfolio, Chicago's Continental Illinois bought participations in oil and gas loans from Oklahoma's Penn Square Bank, relying on Penn Square for credit monitoring and documentation. When a number of its borrowers defaulted, Penn Square failed and Continental suffered large losses, requiring a costly government bailout. *See Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. (1984).

65. *E.g.*, Samuel H. Talley, *Bank Holding Company Performance In Consumer Finance and Mortgage Banking*, 52 MAG. BANK ADMIN., July 1976, at 42 (finding that bank-affiliated mortgage and consumer finance companies had lower returns on equity than the industry average). This particular study covered 1973-1974, and may not reflect recent experience. On the other hand, at that time, bank holding company affiliates actually enjoyed lower average funding costs than their independent rivals. *Id.* at 44.

66. *See supra* note 26 and accompanying text.

67. *See Managerial Brief: Not So Prudent*, THE ECONOMIST, Aug. 31, 1991, at 59 (describing failed effort by Prudential-Bache, the retail brokerage-insurance conglomerate, to enter wholesale investment banking).

68. This charge has been made by Peter C. Eisenmann, *Diversification and the Congeneric Bank Holding Company*, 7 J. BANK RES. 68, 75-77 (1976).

have been unskilled in operating a diversified conglomerate.[69] Nevertheless, experience does suggest that relying on line-of-business diversification for risk reduction is itself a risky banking strategy. Certainly, it does not account for the financial vitality of the universal bank.[70]

II. UNIVERSAL BANKING AND FINANCIAL SUPPORT

If diversification cannot explain the stability of the universal banking model, why are universal banks seemingly failure-resistant? The answer may lie in the relationship between universal banks and their customers. In Germany and Japan, cross-holdings of stock between banks and their corporate clients are common. Nevertheless, equity investment is simply one of many financial ties that bind banking and commercial concerns. These ties provide a motive for banks to support their customers in times of financial hardship,[71] but the converse is true as well: Bank customers are a source of financial and managerial strength for their banks. This particular strain of the universal banking model, however, shows no sign of taking root in the United States.[72]

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69. For some of the reasons why this may have been so, see Garten, *supra* note 22, at 365-69.

70. Some advocates of expanded bank powers may agree, but may argue that risk reduction can be achieved by encouraging banks to abandon unprofitable lending altogether and to concentrate on higher valued businesses. In the early 1980s, many nonbank firms were eager to acquire deposit-taking institutions that did not make any commercial loans (the so-called "non-bank banks"). Banks may prosper by following a similar route, combining their deposit-taking powers with securities, insurance or other nonlending businesses.

This strategy may make sense for some banks, given the current state of the corporate lending business, but it is not universal banking, at least as practiced successfully by the universal banks of Europe. As the next section of this paper will discuss, European universal banks, particularly the German banks, are still primarily business lenders. Stable lending relationships not only facilitate the cross-marketing of universal banking services; they also may be the real reason why universal banks successfully weather financial distress.

71. For a more complete discussion of this point, see Helen A. Garten, *Institutional Investors and the New Financial Order*, 44 RUTGERS L. REV. 585 (1992).

72. This section offers a model of bank-client relationships in universal banking systems. Although the German and Japanese experience offers considerable support for this model, further empirical study is necessary. Moreover, the model offers only a partial explanation of the stability of universal banking systems. *See infra* text accompanying note 134.

A. Bank-Client Relationships in Universal Banking Systems

The universal banking strategy of offering multiple financial services to corporate clients has facilitated the building of remarkably stable banking relationships. As previously suggested, most universal bank clients maintain one or more main-bank relationships that may involve credit and securities services.[73] The marketing strategies of United States-style universal banks also appear to be based on fashioning new "webs of economic interests" between corporate clients and their banks.[74]

Stable client relationships may strengthen banks in several ways. Long-term relationships enhance the predictability of earnings, improving the bank's ability to manage risk. In addition, stable relationships facilitate credit monitoring. When bankers know their customers well, they are better able to assess credit quality and to identify potential problems. Likewise, when their clients depend on long-term banking relationships for credit and other banking services, bankers have more leverage to bargain for stringent credit controls in their loan agreements or to insist on other monitoring devices, such as representation on their borrowers' boards of directors.

Stable client relationships may benefit banks in a more direct way. Once corporate clients build long-term relationships with their banks, they have a financial stake in the continuation of those relationships. This provides a motive for commercial firms to help their banks to weather financial crises. In Germany, for example, credit monitoring is a two-way street.[75] Banks own shares in and influence the management of their corporate borrowers.[76] Likewise, large industrial corporations own shares in and appoint representatives to the supervisory boards of their banks, including the "*Grossbanken.*"[77]

These corporate-banking partnerships mean that, in the event of a banking crisis, the industrial sector has strong incentives to provide financial support to the banking industry. More importantly, corporate influence may shape bank management policy ex ante. Symbiotic bank-customer relationships encourage mutual risk aversion. Banks obviously have an interest in avert-

73. *See supra* note 46 and accompanying text.

74. *See supra* text accompanying notes 56-61.

75. Kübler, *supra* note 9, at 109.

76. Deutsche Bank, for example, holds a 28.5% stake in Daimler-Benz. Kübler, *supra* note 9, at 100.

77. Kübler, *supra* note 9, at 109.

ing the failure of major borrowers. Likewise, large bank clients have reason to fear bank failure and the resulting disruption of banking services. This suggests that corporate customers have reason to insist that their banks adopt risk averse management strategies.[78]

So do universal banks prosper because their customers will not let them fail? The story is actually a little more complex. In both Germany and Japan, for example, the stable bank-client relationships that we associate with universal banking developed as a defensive response to thin or uncompetitive capital markets. In Japan, domestic capital shortages after World War II, coupled with fear of foreign dominance of Japanese capital markets, led to the formation of the bank-centered *keiretsu*.[79] From 1950 through 1980, Japanese firms obtained most of their external financing from bank loans.[80] Even when firms issued new securities, they generally could count on their group bank (and other group members) to subscribe for a portion of the new shares, thereby keeping corporate control in friendly hands.[81]

In Germany, long-term bank-client ties are also the product of underdeveloped domestic capital markets. As of the end of 1985, equity instruments accounted for only 7.2 percent of net long-term obligations of nonfinancial companies. Bank loans accounted for 64.4 percent.[82] Public securities markets are thin compared with United States markets. Access to the markets is controlled by the largest banks, which, through bank syndicates, dominate securities placement and admission to trading on the stock exchanges.[83] In the past, bank fees for securities underwriting have been high, discouraging first-time issuers.[84] From 1986 to 1987, only forty-five new German companies were admitted to the German stock exchange. In contrast, 2,108 new American companies were admitted to United States exchanges in the

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78. Kübler, *supra* note 9, at 109.

79. *See* Anchordoguy, *supra* note 45, at 58.

80. Jack McDonald, *The Mochiai Effect: Japanese Corporate Cross-holdings*, J. PORTFOLIO MGMT., Fall 1989, at 90, 93.

81. *Id.* at 93.

82. Kallfass, *supra* note 38, at 785-86 n.38.

83. Kallfass, *supra* note 38, at 779-80. The absence of significant government supervision of the securities markets has encouraged German banks to act as private market regulators. Although this has undoubtedly protected investors from risky issuers and unfair trading practices, it also has prevented entry into the securities business by new (non-bank) financial intermediaries. Kallfass, *supra* note 38, at 779.

84. Kallfass, *supra* note 38, at 780.

same period.[85] By exercising proxies on behalf of individual equityholders, German banks account for roughly ninety percent of the votes in publicly held firms.[86]

This suggests that long-term banking relationships survive because of the absence of efficient alternatives for capital-seeking firms. Universal banks can control access to capital so long as public capital is scarce, as was the case in post-war Japan, or so long as banks are able to satisfy the commercial sector's demand for external financing, as apparently is still true in Germany.[87] Since corporate customers depend on the banking relationship for access to funds, bank stability is a high priority for the corporate sector.

Conversely, as capital markets mature and expand, long-term banking relationships become less important. This has happened in Japan over the last decade as Japanese companies have become global in operation. These firms have been forced to look beyond the banking system for financing by raising funds in revitalized domestic securities markets[88] and in the international capital markets.[89] As a result, *keiretsu* ties are loosening. Huge city banks such as Mitsubishi have lost their traditional client base of large corporate borrowers. As of 1991, seventy-five percent of Mitsubishi's domestic loans were to individuals and small businesses.[90]

If stable client ties are a significant source of financial strength for banks, Japanese banks may now be contemplating the loss of this support at the time when they most need it. Recent events have called into question the stability of the Japanese banking system.[91] Like their United States counterparts,

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85. Kallfass, *supra* note 38, at 775-76 n.2.

86. Kallfass, *supra* note 38, at 782.

87. *See* Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 35-36 (1991). One reason that banks continue to dominate the German credit markets is that German firms do not have to borrow very often, relying instead on internally generated funds, including reserves set aside to fund corporate pensions. *See* Kallfass, *supra* note 38, at 789. When German firms do borrow, German banks can still satisfy loan demand, removing the need for alternative funding sources. Moreover, German banks' access to inexpensive capital (and their control over underwriting fees) can keep loan rates low relative to other funding sources. *See infra* text accompanying notes 93-98.

88. For a discussion of the recent growth of the Japanese commercial paper market, see Litt et al., *supra* note 7, at 423-28.

89. *See generally* McDonald, *supra* note 80, at 93.

90. *See Japanese Banking: Mitsubeautiful*, THE ECONOMIST, Feb. 9, 1991, at 86 [hereinafter *Mitsubeautiful*].

91. *See* Robert M. Garsson, *Japanese Banks Are Poised on a Precipice*, AM.

Japanese banks are experiencing unprecedented financial difficulties.[92] The loss of stable corporate lending relationships has encouraged Japanese banks to diversify into unfamiliar lending areas, including high risk real estate lending. Interest rate deregulation has put additional pressure on bank earnings.[93] The results in Japan have been the same as in the United States. Problem loans are mounting, estimated in 1992 to amount to as much as 418 billion dollars.[94] The debt ratings of some large Japanese banks have been lowered.[95]

These persistent problems besetting a banking industry that has heretofore been virtually failure-free suggest that the *keiretsu* relationship can no longer be counted on as an effective source of monitoring and financial support for Japanese banks. Moreover, even the Japanese government appears reluctant to restore the banking industry to its former glory. According to recent reports, the government would prefer to use the current banking crisis to bring about a long-term reduction in the size and role of the banking system.[96] This may signal a growing consensus that, as banker dominance of the credit markets wanes, a stable banking sector is no longer considered essential to a stable industrial sector.

B. Stable Capital

Long-term client relationships may also ensure universal banks access to stable, low-cost capital. As central bankers in

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BANKER, July 27, 1992, at 10A.

92. *Id.*

93. *Id.*

94. *Id.*

95. *See Mitsubishi and Dai-Ichi Debt Is Downgraded*, AM. BANKER, Aug. 26, 1992, at 7.

96. *See International News: Japanese Banks Seen Facing Tough Decade*, AM. BANKER, June 12, 1992, at 12. It is still unlikely that Japan will actually allow its banks to fail. Maintaining international confidence in the stability of its financial markets remains important government policy. *See infra* text accompanying notes 161-64. Moreover, in 1992, concern over a possible credit crunch in some business sectors seemed to be forcing the government to offer financial assistance to the banking sector by intervening to support real estate prices, despite its stated reluctance to use public monies to prop up bank profits. *See International News: Japan's Recovery Called Dependent on Bank Lending*, AM. BANKER, Aug. 12, 1992, at 9. In late October 1992, the government announced a plan to allow banks to sell troubled real estate loans to a newly formed corporation to be capitalized by the banking industry. Although the government still insisted that public funds would not be contributed, the plan did contemplate significant tax breaks for banks. James Sterngold, *Japan Says Bad Bank Loans Soared by 50% in Six Months*, N.Y. TIMES, Oct. 31, 1992, at 37, 48.

industrialized nations have moved toward the adoption of uniform minimum capital requirements, patient capital has become increasingly important for banks.[97] In Germany, important bank customers often hold long-term equity stakes in their banks.[98] In Japan, the *keiretsu* was characterized by complex equity cross-holdings that ensured that some percentage of bank stock remained permanently in the hands of friendly bank clients.[99]

Because these equity stakes serve primarily as a source of monitoring and influence rather than as an investment for profit, they are seldom if ever traded. Banks are insulated to a degree from the vicissitudes of the competitive capital markets. Moreover, when banks need to raise new capital, existing customer-shareholders that want to prevent dilution of their interests have an incentive to buy new shares.

Long-term customer relationships may also enable banks to attract deposits from corporate clients and their employees. This may help to explain why German banks traditionally have enjoyed a stable low-cost deposit base.[100] In Japan, *keiretsu* connections may be breaking down as corporate firms look beyond banks for funding, but *keiretsu* banks can still count on stable retail deposits collected from employees of group companies.[101]

The link between stable corporate-banking relationships and stable deposits has another explanation. Both are products of relatively undeveloped securities markets. Savers favor bank deposits because of the limited number of investment alternatives. In Germany, for example, individual participation in the public securities markets is low. Roughly half of all listed stock is held by the corporate sector.[102] These blocks of equity are held less for investment than as a way to cement inter-corporate relationships and are rarely traded. As of 1990, only six percent of firms listed on the Frankfurt stock exchange had over half of their stock in public float.[103] Investment funds for small savers comparable to United States mutual funds are practically

97. *See* Helen A. Garten, *Whatever Happened to Market Discipline of Banks?*, 1991 ANN. SURV. AM. L. 749 (1992).

98. *See supra* text accompanying note 77.

99. For example, as of 1989, within the Mitsubishi group, Mitsubishi Corporation owned 1.9% of Mitsubishi Bank. Mitsubishi Heavy Industries owned another 3.5% of the bank's stock. McDonald, *supra* note 80, at 90.

100. Buxbaum, *supra* note 87, at 37.

101. *Mitsubeautiful, supra* note 90, at 87.

102. Kallfass, *supra* note 38, at 786.

103. Buxbaum, *supra* note 87, at 19 n.72.

nonexistent.[104]

The experience in the United States has been very different. Pension funds and, to a lesser degree, mutual funds have emerged as significant savings vehicles for individual investors, channelling their funds into the corporate securities markets. Active short-term debt markets such as the market for commercial paper offer a highly liquid alternative to deposits both for direct investors and for money market mutual funds which in turn can offer deposit-like liquidity to small savers. The result has been disintermediation: the outflow of both corporate and retail savings from bank deposits into investment alternatives.

Why are these alternatives more readily available in the United States than in Germany? One reason is that, as securities have replaced bank loans as a significant source of external funding for United States business firms, the securities markets have expanded and matured, offering more choices and greater liquidity for investors. In Germany, banks still dominate credit. Since most business firms do not have to resort frequently to the securities markets for financing, direct investment opportunities are fewer. Bank deposits remain the primary vehicle for channelling savers' funds to the end users of capital.

The connection between a stable deposit base and a stable banking system is also demonstrated by the United States experience. In the 1950s, deposits were so plentiful that many United States banks did not pay any interest at all on corporate time accounts.[105] Since the 1980s, disintermediation has meant higher funding costs, increased liquidity risks and lower net interest margins for the United States banking industry.

The universal banking model does not by itself guarantee a stable deposit base. French banks have universal banking powers, yet they have lost deposits to tax-advantaged money market mutual funds — funds which they have promoted themselves.[106] There are indications that German banks may have protected their deposit base by deliberately suppressing rate competi-

104. Kübler, *supra* note 9, at 99; *see also* Thomas Christian Paefgen, *Institutional Investors Ante Portas: A Comparative Analysis of an Emergent Force in Corporate America and Germany*, 26 INT'L LAW. 327, 328 (1992). German investment companies tend to be subsidiaries of banks. *See* Baums, *supra* note 46, at 505 n.16.

105. George W. McKinney, Jr., *New Sources of Bank Funds: Certificates of Deposit and Debt Securities*, 32 LAW & CONTEMP. PROBS. 71, 72 (1967).

106. Phil Roosevelt, *French Show Vulnerability to Financial Industry Woes*, AM. BANKER, July 27, 1992, at 17A.

tion.[107] Recently, however, even German banks have begun to offer market rates to depositors.[108] In Japan, deregulation of deposit interest rates has already had an adverse effect on bank profits.[109] Thus, although universal banks may still be able to use stable client ties to market deposits, as investment alternatives become more widely available and depositors demand competitive rates of return from their banks, even universal banks will experience higher funding costs and disintermediation.

C. *Can We Copy the Universal Banking Model?*

Some United States banking reformers would try to reproduce the stable bank-client relationships of the universal banking model by changing the law to permit corporate firms to own banks.[110] Ideally, corporate owners would have the same incentives as, say, German industrial firms to provide ongoing monitoring and financial support for their banks.

As the previous section has suggested, however, German firms have an interest in the stability of their banks because they still depend on banks for most of their financial needs. Ongoing business ties are likely to encourage mutual risk aversion and provide incentives for failure avoidance.[111]

In contrast, as a "pure" shareholder, a United States commercial firm may have no more incentive than today's bank owners to prevent bank failure. First, corporate owners are likely to be diversified, which in theory should allow them to tolerate more risk than undiversified stakeholders.[112] Second, debt-dominated bank capital structures and bank regulation actually create disincentives for corporate owners to rescue ailing bank affiliates. If the corporate owner contributes new capital, most of its investment will go to pay off depositors' claims. If the corporate owner refuses to invest new money and the bank fails, the insur-

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107. *See, e.g., Germany Probing How Biggest Banks Set Rates on Savings,* AM. BANKER, Aug. 26, 1992, at 7 (government probe into alleged price fixing by largest banks to keep deposit rates low).

108. Kraus, *supra* note 49, at 8A.

109. Garsson, *supra* note 91, at 10A.

110. *E.g.,* TREASURY RECOMMENDATIONS, *supra* note 1, at 56-57. Such affiliations are now forbidden by section 4 of the Bank Holding Company Act, 12 U.S.C. § 1843(a) (1988).

111. *See supra* text accompanying notes 75-78.

112. This may not be true if, as I have argued with respect to bank holding companies, conglomerate managers have a reputational stake in averting the failure of *any* business unit. *See* Garten, *supra* note 22, at 359-61.

ance fund must reimburse depositors. Thus, once a bank affiliate begins to experience financial difficulty, the corporate owner has reason to shield healthy assets from bank creditors, shifting the cost of failure resolution to the deposit insurance fund. In the past, bank owners have often tried to walk away from their failing banks, leaving the government to sift through the wreckage.[113]

So is the answer to allow cross-ownership *and* unlimited financial interconnections between commercial and banking firms? This approach would be far more radical than past reform proposals, all of which have included some "firewalls" preventing funds transfers and other financial transactions between a bank and its commercial owner.[114] Nevertheless, even complete deregulation would not necessarily reproduce the stable symbiotic relationships of the universal banking model. The problem, simply put, is competition. In the highly competitive United States financial services markets, corporate borrowers simply have too many choices to be willing to risk their capital to save their banks. Moreover, most observers see this as a strength, not a weakness, of the United States financial system.

1. A Historical Detour: Henry Ford and the Michigan Banking Crisis of 1933

Before 1933, the United States did have a version of the universal bank. Legal lines of demarcation between permissible and impermissible banking activities had not yet been clearly drawn and banks could diversify fairly freely.[115] Private banks like the House of Morgan guided large corporate clients through the capital raising process, offering loans, securities underwriting, restructuring advice and shareholders' services, including

113. This problem has caused bank regulators to try to force bank holding companies to contribute capital to troubled subsidiary banks. *See, e.g.*, MCorp Fin., Inc. v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 852 (5th Cir. 1990), *rev'd in part on other grounds*, 112 S. Ct. 459 (1991). *See also infra* text accompanying notes 168-69 (describing statutory provisions mandating capital contributions by affiliated entities). If today's bank holding company will not voluntarily contribute non-bank assets to assist its bank, it is unclear why diversified commercial owners will be any more willing to do so.

114. *E.g.*, TREASURY RECOMMENDATIONS, *supra* note 1, at 59 (endorsing financial and disclosure firewalls between insured banks and non-bank affiliates).

115. Modern legal restrictions on diversification were the product of the Banking Act of 1933 (separating banks and securities firms) and the Bank Holding Company Act of 1956 (separating banks and commercial firms).

voting proxies for stockholders.[116] By the 1920s, even traditional deposit-lending banks like Chase National Bank and National City Bank were engaging in securities activities through affiliates.[117]

Were these banks able to build the stable client relationships that would see them through periods of financial distress? Some banks, notably the successful private banks, were stronger than most of their clients and never needed their help. After the stock market crash of 1929, the House of Morgan's net worth dropped,[118] but Morgan and its affiliated banks were hardly in danger of failing.

But what about those banks that were threatened? Did long-standing client relationships provide a source of strength? One anecdote is revealing. In February 1933, Union Guardian Trust, one of Michigan's two largest banks, was close to insolvency. The Hoover Administration was ready to lend to the bank through the newly created Reconstruction Finance Corporation (RFC), but only if Henry Ford, a large depositor, was willing to subordinate his deposit liabilities to the government's loan. Ford was not just a major bank customer. A member of the Ford family had served on the bank's board and Ford had provided financial support to the bank in the past.[119]

This time, however, although the bank's failure was imminent, Ford refused to help and even threatened to withdraw twenty million dollars of corporate deposits from Michigan's other main bank.[120] The RFC did not make the loan, the governor of Michigan was forced to proclaim a bank holiday and panic spread quickly through the rest of the banking industry.[121] For many observers, this marked the beginning of the banking crisis that eventually led to the nationwide bank holiday of March 1933.[122]

Interestingly, in 1916, Henry Ford had turned down an offer from the House of Morgan to take his company public.[123] Later,

116. *See supra* text accompanying notes 53-55.

117. Perkins, *supra* note 3, at 492.

118. *See* CHERNOW, *supra* note 53, at 349.

119. *See* JESSE H. JONES, FIFTY BILLION DOLLARS: MY THIRTEEN YEARS WITH THE RFC (1932-1945), at 58 (1951).

120. *See* ARTHUR M. SCHLESINGER, JR., THE AGE OF ROOSEVELT: THE CRISIS OF THE OLD ORDER 1919-33, at 475 (1956).

121. *Id.* at 476.

122. *Id.* at 475.

123. CHERNOW, *supra* note 53, at 222.

Morgan did underwrite a securities offering for rival GM and played an active role in rescuing GM when, shortly after the public offering, GM's stock price plummeted, leaving the underwriters holding quantities of unsold shares.[124] Thereafter, GM remained a loyal Morgan client. In contrast, Henry Ford apparently did not need Morgan, Union Guardian Trust or any other bank for continued access to capital or other financial services. As a result, he did not have sufficient incentives to ensure their survival when they experienced financial distress.[125]

2. Modern Examples: The United States Version of the Universal Bank

Today's quasi-universal banks, like Morgan and Bankers Trust, are successfully marketing related financial services to clients. Nevertheless, they are not likely to build the symbiotic relationships that are central to the universal banking model.

First, the quasi-universal bank faces substantial competition both in the market for linked financial services and in each individual product market. For example, universal banks may offer clients a package of capital market services, including lending plus underwriting plus financial advice. In doing so, they compete with diversified securities firms, which offer the same package of services, and with a variety of "boutique" firms that offer specialized products such as merger and acquisition advice. In contrast, in most other countries, there are simply fewer financial services firms with the ability to meet the needs of large or medium-sized companies. Either a few huge banks dominate the wholesale market, as in Germany, or banks have enjoyed a captive customer base, as in the Japanese *keiretsu*.[126]

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124. CHERNOW, *supra* note 53, at 223-24.

125. In the case of Union Guardian Trust, Ford's refusal to help may have been motivated in part by his dislike of government assistance programs such as the RFC. *See* SCHLESINGER, *supra* note 120, at 475. Nevertheless, had Ford truly believed that his business fortunes depended on the survival of the Michigan banking system, he might have been forced to sacrifice principle to expediency.

126. For further discussion of banking oligopolies in Germany and Japan and their contribution to banking stability, *see infra* text accompanying notes 133-43.

As previously noted, Morgan has successfully drawn on existing customer relationships to market new financial products, including merger and acquisition advice. *See supra* text accompanying notes 52-55. According to a Morgan banker, "It would be very rare for us to go knock on the door of a [client] that Morgan does not have a relationship with." Kelley Holland, *Morgan, BT Carve a Bank-Merger Niche*, AM. BANKER, Oct. 28, 1992, at 1, 8. Nevertheless, the market for merger and acquisition advice is so competitive that even Morgan is unlikely to dominate (in 1992, Morgan ranked 11th in market

Second, the tie that traditionally has bound the corporate client to its bank — the lending relationship — is no longer so important in United States financial markets. When loans account for most of the corporate sector's intermediate or long-term financing, universal banks can build on lending relationships to introduce customers to other products. Symbiotic multiservice relationships can be formed. In the United States, the largest industrial firms have been able to replace bank loans with commercial paper or medium-term note programs. As long as the issuer can roll over its paper at maturity, these short-term obligations can become a long-term funding source.

Moreover, many frequent issuers have even been able to place their paper without the assistance of a securities dealer.[127] Firms that can raise funds directly from investors do not need a stable long-term relationship with a financial intermediary. United States universal banks may become niche players, assisting companies with occasional esoteric financing problems rather than with their ongoing funding needs. In contrast, even huge German corporations like Siemens and Hoechst remain important banking customers.[128]

What explains this difference between United States and German capital markets? One answer may be the relative appetites of German and United States firms for outside capital. According to Professor Richard Buxbaum, German firms have remained smaller and less conglomerate than their United States counterparts and therefore fit more readily into bank-dominated capital markets.[129] In contrast, the appetites of many United States firms for capital have outgrown the banking system. A significant factor contributing to the rapid growth of the United States commercial paper market in the 1960s and 1970s was the inability of banks to meet the capital demands of expanding

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share). Cross-marketing provides a competitive edge, but it is not the only way to succeed. Bankers Trust (ranked 26th) has followed another approach, advertising its expertise in complex restructurings and other esoteric transactions. *Id.* at 8.

127. Between December 31, 1974 and April 30, 1982, the amount of commercial paper placed directly with investors increased approximately 150%. Evelyn M. Hurley, *The Commercial Paper Market Since the Mid-Seventies*, 68 FED. RESERVE BULL. 327 (1982). *See also* Julian Lewis, *Cutting Out the Middle Man*, EUROMONEY, Feb. 1990, at 62 (describing expansion of direct dealing between securities issuers and investors).

128. Kübler, *supra* note 9, at 109. For example, the largest corporations rely on stable banking relationships for continuing export financing. Kübler, *supra* note 9, at 109.

129. Buxbaum, *supra* note 87, at 35-36.

companies.[130] Likewise, during the past decade, multinational Japanese corporations have outgrown the stable financing relationships provided by the *keiretsu* and have been forced to seek funds in the international securities markets.[131]

Of course, not all business firms can raise funds directly from the securities markets, as recent complaints about a "credit crunch" in both the United States[132] and Japan[133] demonstrate. Small businesses in particular may still benefit from stable banking relationships. Yet these businesses are also too small to provide effective monitoring and financial support for banks. In Germany, where banks still dominate the capital markets, the largest corporations efficiently perform these functions. In the United States, the largest corporations have few incentives to do so, since their access to capital no longer depends on the survival of the banking industry. This suggests that allowing United States banks to offer more financial services will give corporate firms more choices, but will not create the interdependencies that may be a source of financial support for German universal banks.

Finally, the apparent stability of universal banks is not fully explained by symbiotic bank-client relationships. Even in Germany, there have been occasional bank failures, notably Bankhaus I.D. Herstaat in 1974.[134] This suggests that stable bank-client relationships do not offer complete protection from financial stress.

Moreover, as financial markets become truly global, banker domination of the capital formation process is likely to be challenged even in universal banking systems. In Japan, banks have already lost a large portion of their traditional corporate lending base.[135] Even German banks will be forced to compete in increasingly integrated European markets.[136] As capital moves more freely through the European Community,[137] the stable

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130. Evelyn M. Hurley, *The Commercial Paper Market*, 63 FED. RESERVE BULL. 525, 532 (1977).

131. *See Mitsubeautiful, supra* note 90, at 87.

132. *E.g.*, Barbara A. Rehm, *Senators Turn Up the Heat Over Pullback in Lending*, AM. BANKER, Aug. 6, 1992, at 1.

133. *See supra* note 96.

134. *See GAO Study, supra* note 2, at 33.

135. *See supra* text accompanying notes 88-96.

136. *See supra* text accompanying notes 51-52.

137. Many financial observers believe that this particular goal of European unity has already been achieved as a practical matter, despite political developments that may

lending relationships enjoyed by German banks may suffer the same erosion that occurred in the United States in the 1970s and in Japan in the 1980s. For German banks, this may mean lower profits and perhaps even a diminished role in the financial sector.[138]

Despite these new challenges, however, no one expects the German or Japanese banking systems to experience the high failure rates and dislocation that have affected American banks. There must be other reasons why non-United States banking systems are more stable than our own. As will be shown, these reasons have little to do with the universal banking model.

III. UNIVERSAL BANKING AND FINANCIAL OLIGOPOLY

One explanation of the apparent stability of many non-United States banking systems is their predominantly oligopolistic banking structure. The United States has approximately 12,800 commercial banks.[139] Germany has 4,400 banks, but 1,200 of these are very small, with a business volume of less than 28.4 million dollars as of 1989.[140] The Big Three banks dominate, accounting for most securities underwriting,[141] trade finance and letters of credit.[142] Both Japan and France have fewer than 500 banks.[143]

Thus, one factor contributing to the high rate of bank failure in the United States may be overcapacity. Until recently, United States banks enjoyed regulatory subsidies (such as inexpensive deposit insurance and interest rate ceilings on deposits) and protected product and geographic markets. Many of these subsidies reflected deliberate government policy to protect a banking system consisting of large numbers of independent local banks.[144] Recently, deregulation and competitive pressures have ended the industry's ability to sustain a full service bank on every corner. As the industry adjusts, bank failure rates inevitably will be high.

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be slowing formal legal and economic integration. *See* Loehnis, *supra* note 51, at 1A.

138. *See* Kraus, *supra* note 49, at 8A.

139. *GAO Study*, *supra* note 2, at 32 n.5.

140. *GAO Study*, *supra* note 2, at 32.

141. Kallfass, *supra* note 38, at 780.

142. *GAO Study*, *supra* note 2, at 14.

143. *GAO Study*, *supra* note 2, at 32.

144. This apparently was a goal of federal deposit insurance. *See* Carter H. Golembe, *The Deposit Insurance Legislation of 1933*, 76 POL. SCI. Q. 181 (1960).

Nevertheless, even when overcapacity is not a factor, concentrated banking systems may be inherently more stable than fragmented systems. One reason may be that oligopoly facilitates regulatory oversight.[145] Bank examiners have fewer banks to monitor. To the extent that market discipline can be relied upon as an adjunct to government supervision, professional securities analysts and investors are more likely to follow a handful of large banks than thousands of smaller banks.

Of course, as bank size and complexity grow, monitoring becomes more difficult. Moreover, the consequences of monitoring failure are more severe, affecting large numbers of customers and investors. On the other hand, as the number of banks decreases, their visibility increases. This may make bank managers susceptible to pressure from regulators, the press and investors to operate their banks responsibly.

Perhaps most important, oligopoly may encourage collective action by banks to solve their own problems. The smaller the number of players in the banking system, the more likely it becomes that interbank exposures and other business ties will give each bank a sufficient stake in the others' survival to justify collective action to avert failure. Further, the failure of a major player in a concentrated banking market can easily shake public confidence in the entire banking system, directly affecting the survivors. Finally, coordinated action is easier when participants are few. Free riders can be identified and disciplined.

In Germany, banks have acted collectively to help ailing banks resolve their problems. For example, in 1983, the banking industry participated in a joint effort to rescue Schroder, Munchmeyer, Hengst & Co., which had banking operations in Germany and Luxembourg.[146] Rescue operations usually have taken place through the private Federal Association of German Banks, which also administers the deposit insurance system.[147] The Association puts pressure on member banks to provide financial assistance to a troubled bank and coordinates rescue efforts with the bank regulators.[148] German regulators believe that their banks' stake in preserving international confidence in the banking system provides a strong motive for voluntary collective

145. Central bankers in Europe and Japan believe that this is the case. *See GAO Study, supra* note 2, at 31.

146. *GAO Study, supra* note 2, at 34.

147. *GAO Study, supra* note 2, at 34.

148. *GAO Study, supra* note 2, at 15.

action to avert a major failure even if participating banks suffer short-term losses.[149]

In the United States, joint action is more costly and offers fewer benefits for individual banks. Although healthy banks are often asked to maintain existing credit lines to ailing banks until the government can arrange a permanent solution, industry-wide rescues, particularly those involving private capital injections, have been rare. In the 1930s, President Hoover tried to persuade healthy banks to act jointly to provide a credit reserve for banks experiencing financial difficulties, but efforts to rely on voluntarism failed. Most bankers insisted that financial support was the government's responsibility. Shortly thereafter, a government agency was set up to perform this function.[150]

Since the 1930s, the government has continued to bear most of the burden of recapitalizing or liquidating failing banks.[151] Healthy banks have occasionally been persuaded to participate, but only in special circumstances[152] — and when the government has committed to bear most of the risk.[153] Even when a

149. *GAO Study*, *supra* note 2, at 34.

150. The agency was the Reconstruction Finance Corporation. *See* SCHLESINGER, *supra* note 120, at 236.

151. To the extent that the government pays for failure resolution out of the deposit insurance fund, all banks that are required to pay insurance premiums ultimately share the financial burden. Nevertheless, when failure resolution costs have been high, healthy banks have not been willing to contribute additional amounts to assist troubled banks or the insurance fund. In the 1930s, for example, funds for recapitalizing the banking industry came from the government-sponsored Reconstruction Finance Corporation, not from the deposit insurance fund. *See* JONES, *supra* note 119, at 13-53. Moreover, healthy banks have rarely been willing to act collectively to avert failure by providing either financial support or managerial guidance to ailing banks *before* government intervention is needed. Today, as in the 1930s, bank rescues remain the responsibility of government. Private participation extends only to paying mandatory deposit insurance premiums. In contrast, in Germany, the private banking sector has taken the lead in arranging and funding bank rescues, making government intervention (or resort to formal deposit insurance assessments) unnecessary in most cases.

The negative attitude of most U.S. banks toward voluntary collective action to avert failure is suggested by the industry's generally positive response to the introduction of risk-based deposit insurance premiums. *See infra* text accompanying note 155. Now the healthiest banks can expect to bear even less of the financial responsibility for assisting the weakest players. In Germany, the expectations of the strongest banks are exactly the opposite.

152. For example, in 1971, Boston banks participated in the bailout of the minority-owned Unity Bank. Even in this case, however, the banks insisted on a substantial injection of public capital. Moreover, although the banks agreed to provide ongoing management training, it proved unsuccessful. Unity failed again, requiring another government rescue. *See* IRVINE H. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 35-52 (1986).

153. For example, in the rescue of First Pennsylvania, which is usually cited as an

healthy bank agrees to take over a failing bank's franchise, the government routinely provides attractive financial incentives, including protection against future losses.[154]

This suggests that United States banks do not have adequate financial incentives to participate in German-style private rescues of ailing banks. (In fact, healthy banks have long complained that their deposit insurance premiums are already too high, subsidizing weaker institutions.[155]) There are simply too many banks, and too many banks that need rescuing. Moreover, recent United States bank regulatory policy has actually tried to discourage interbank exposures and other financial interconnections among banks that could provide a motive for mutual assistance.[156]

Although oligopoly may enhance the stability of a banking system, oligopolistic banking systems are not necessarily universal banking systems. British banking traditionally has been dominated by a handful of players, but until recently the large clearing banks did not exercise the powers of universal banks.[157]

Conversely, in the United States, permitting banks to enjoy universal banking powers will not necessarily lead to greater industry concentration. Although critics occasionally have warned of the coming of the financial behemoths (such as a combined Citicorp-Merrill Lynch), there are already so many independent players in every corner of the United States financial services markets, including both diversified and specialized firms, that we are unlikely to match the degree of financial concentration that is seen in Germany. Although no one expects 12,000 independent banks to survive into the next century, industry shrinkage is likely to proceed slowly, through intra-industry mergers and failures, rather than through the fashioning of a handful of giant banking-industrial combines.[158]

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example of successful collective action by the banking industry, private banks participated reluctantly, providing loans of just $175 million to the FDIC's $325 million. *Id.* at 92-95.

154. *See* John F. Bovenzi & Arthur J. Murton, *Resolution Costs of Bank Failures*, 1 FDIC BANKING REV. 1 (1988).

155. Recently mandated risk-based deposit insurance premiums may address this concern. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2245, § 302 (amending 12 U.S.C. § 1817(b) (1988)).

156. *E.g.*, Federal Deposit Insurance Corporation Improvement Act of 1991, § 308 (adding new § 23 to the Federal Reserve Act) (requiring Federal Reserve to limit interbank deposits and other interbank exposures).

157. *See supra* note 3.

158. Based on the experience of the thrift industry when barriers to affiliation with

One caveat must be noted. Although oligopolistic banking structures may facilitate collective action to avert failure of individual banks, they are vulnerable to system-wide financial distress. Financial interconnections among banks may be so extensive that the collapse of one institution leaves other players too weak to participate in a coordinated rescue effort. This suggests the significance of early intervention to resolve banking problems before they become contagious. As the next section will describe, such early intervention is characteristic of stable banking systems.

IV. Universal Banking and Government Policy

Another explanation of the low failure rates in many non-United States banking systems is the role of government action. Bank regulators around the world typically deny that they follow a "too big to fail" policy.[159] Technically, this is accurate, since few banks are allowed to deteriorate to the point where failure is imminent. Instead, direct and indirect government action ensures prompt correction of banking problems.

In many cases, government action simply means creating incentives for private self-help. In Japan, for example, the Ministry of Finance (MOF) traditionally has encouraged a policy of "mutual aid" whereby the large city banks have rescued smaller banks that have experienced financial difficulty. Although these city banks do not have an obvious financial stake in the survival of local institutions, the MOF has encouraged cooperation through its jealously guarded control over the granting of branch licenses. If city banks want permission to expand their operations, they must comply with regulatory requests for voluntary mutual assistance.[160]

Recently, the financial problems experienced by many city banks in Japan have made mutual aid more difficult to enforce. Nevertheless, observers of the Japanese banking system (including, significantly for Japanese banks seeking capital from international securities markets, the rating agencies) doubt that United States-style bank failures will occur.[161] This does not

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commercial firms were lifted, analysts have predicted that allowing commercial-banking affiliations is unlikely to result in massive cross-industry acquisitions. *See* Debra Cope, *Outside Capital May Be Hard to Come By*, AM. BANKER, Oct. 17, 1991, at 1.

159. *GAO Study*, *supra* note 2, at 33.

160. Sender, *supra* note 43, at 130.

161. *See Japanese Banks Seen Facing Tough Decade*, *supra* note 96, at 12.

necessarily mean that the Japanese government will recapitalize the banking industry either by direct financial assistance or by regulatory subsidy (such as reimposing interest rate ceilings on deposits).[162] There are indications that the government's long-term policy will be to encourage banks to shrink, cutting back their extensive international operations.[163] Nevertheless, government involvement will ensure that industry restructuring takes place, and that it takes place peacefully through merger or divestiture rather than through failure.[164]

Other banking systems also contemplate a major government role in averting bank failure, usually by engineering private recapitalizations of weak banks. In France, the central bank may call upon the major shareholders of a troubled bank to rebuild its capital base, a procedure used in 1988 to rescue Al Saudi Banque, S.A.[165] Of course, assessability schemes are not always successful.[166] In the case of Al Saudi, many of the bank's foreign shareholders refused to cooperate. The French central bank then called upon the French financial community, including both banks and money market funds that held deposits in Al Saudi Banque, to supply the needed funds.[167]

How do these approaches differ from the United States ap-

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162. *See supra* text accompanying note 91. *But see supra* note 96 (suggesting reasons why the Japanese government may be forced to support the banks, at least in the short term).

163. *See supra* text accompanying note 96. *See also* James R. Kraus, *Foreign Banks' Growth in U.S. Comes to Halt*, AM. BANKER, Oct. 14, 1992, at 1 (6% decline in U.S. assets held by Japanese banks during first half of 1992 reflects a conscious decision to pull back from U.S. markets).

164. The restructuring plan announced in October 1992 suggests that, notwithstanding its pledge not to use public monies to recapitalize the banking industry, the Japanese government will remain actively involved in resolving bank problems. The plan contemplates a combination of private collective action (the banks will finance a new corporation to buy troubled loans) and government assistance in the form of tax breaks. *See supra* note 96. Nevertheless, many analysts believe that this plan is inadequate and that the government is underestimating the extent of the banking crisis. Sterngold, *supra* note 96, at 37. If, as most observers still believe, the Japanese government remains committed to preserving the stability of its banking system, it may be forced to take additional steps to rescue the industry.

165. *GAO Study, supra* note 2, at 35.

166. One problem is that diversified shareholders do not always have a sufficient financial stake in their bank's survival to contribute voluntarily. *See supra* text accompanying note 112. Legal action against dispersed and, in the Al Saudi case, foreign shareholders is costly or impossible. In any case, most non-U.S. central banks apparently prefer to resolve bank problems through cooperative efforts rather than through formal legal proceedings. *See infra* note 173.

167. *GAO Study, supra* note 2, at 35.

proach? First, United States bank regulators traditionally have had limited legal or moral authority to compel private players, whether shareholders, depositors or other banks, to recapitalize troubled institutions. Over the past few years, Congress has increased the bank regulators' authority to seek contribution at least from affiliated corporate entities. When a bank fails, the deposit insurance fund may now seek reimbursement for its failure resolution costs from "commonly controlled depository institutions."[168] Bank holding companies may be called upon to guarantee the recapitalization of an undercapitalized bank subsidiary in an amount up to five percent of the undercapitalized bank's assets.[169]

The efficacy of these provisions, however, depends on the capacity of affiliated entities to contribute resources to their ailing banks and their willingness to do so without a protracted legal battle. Experience suggests that affiliated entities may prove to be an unreliable source of financial support for ailing banks. If, as is likely, the financial burden is substantial, affiliated companies may not have sufficient assets to meet their obligation. The result of enforcing contribution will be the failure of the entire organization, which may facilitate its sale as a package but which will hardly avert bank failure.

Moreover, if the bank is already so weak that failure is inevitable, affiliated entities have no incentive to cooperate, forcing the government to commence costly legal proceedings.[170] In contrast, as suggested by the French experience, nonaffiliated parties with a substantial financial stake in the bank's survival may actually be more willing (and able) to share the burdens and benefits of recapitalization.

Second, in the United States, failure prevention policy tends to come into play only after a bank is in dire financial straits. As previously noted, most central bankers outside of the United States deny that they follow the much maligned "too big to fail" policy.[171] In the United States, that policy has meant in

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168. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, § 206(e), codified at 12 U.S.C. § 1815(e) (1988 & Supp. II (1990)).

169. Federal Deposit Insurance Corporation Improvement Act of 1991, § 131 (adding new § 38 to the Federal Deposit Insurance Act).

170. *Cf.* MCorp Fin., Inc. v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 852 (5th Cir. 1990), *rev'd in part on other grounds*, 112 S. Ct. 459 (1991) (protracted litigation by Federal Reserve to enforce its "source of strength doctrine" requiring bank holding companies to provide financial support to affiliated banks).

171. *See supra* text accompanying note 159.

effect that when a large bank like Continental Illinois is on the verge of insolvency, the regulators are likely to provide open bank assistance or arrange a merger with a healthy bank in order to avoid the cost of closing the bank and paying off insured depositors out of the insurance fund. (Recently, Congress has tried to scuttle the "too big to fail" policy by requiring the regulators to prove that these alternatives to liquidation are less costly to the deposit insurance fund in the long run.[172])

Thus, in the United States, the "too big to fail" policy is an approach to failure resolution, not failure prevention. It is invoked only after a bank has experienced such severe financial problems that, without government help, failure is certain. In contrast, other central banks appear to have more flexibility to intervene to prevent potential risks to the banking system that may not yet be sufficiently tangible to allow quantification.[173]

Moreover, the central bank's role in these cases is to encourage collective action by the banking industry to assist troubled institutions, not to expend deposit insurance funds. Deposit insurance comes into play only if the decision is made by the central bank to let a bank fail.[174] Thus, fewer banks actually fail. When they do, in most cases, failure reflects deliberate central bank policy.

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172. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, § 141 (amending 12 U.S.C. § 1823(c) (1988)). Critics of "too big to fail" made three arguments: that open bank assistance and mergers protected uninsured as well as insured depositors; that, as a result, small banks were at a competitive disadvantage in attracting funds; and that liquidation was actually a less costly solution in most cases.

173. *See GAO Study, supra* note 2, at 33-39 (describing central bank policies in Europe, Japan and Canada). Recently, Congress has endorsed a policy of early regulatory intervention in undercapitalized banks. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, § 131 (adding new § 38 to the Federal Deposit Insurance Act). This approach differs from the European approach in two respects. First, Congress has legislated specific actions that bank regulators must take against undercapitalized banks, such as restricting asset growth and the payment of above-market interest rates on deposits. Most central banks prefer flexible case-by-case solutions. *See, e.g., GAO Study, supra* note 2, at 16 (French regulatory policy). Second, early intervention turns on undercapitalization. Undercapitalized banks are expected to attract new capital on their own or face regulatory penalties. In contrast, most central banks encourage some form of mutual aid whereby healthy banks or other market participants are responsible for recapitalizing weak banks.

174. If the central bank has decided to rescue a bank but new private capital cannot be raised from industry participants, can the central bank (or government) use public funds to recapitalize the bank? The answer appears to be yes. In France, for example, the central bank may take "appropriate measures to rescue the bank" if appeals for new private capital have been unsuccessful — or it can let the bank fail and invoke deposit insurance. *See GAO Study, supra* note 2, at 16.

Is an active government failure prevention policy a necessary component of the universal banking model? There may be some connection. The large universal banks of Germany, for example, dominate the capital markets. The failure of any one would cause substantial market disruption, providing a motive for government policy to prevent bank failure. Nevertheless, the strategic significance of these banks to the German economy is also the result of Germany's oligopolistic banking structure. Moreover, in Germany and Japan, failure prevention policies have applied equally to giant wholesale banks and small local institutions.[175] In both nations, the central bank is primarily concerned with maintaining confidence in the banking system, which may involve preventing most, if not all, bank failure.[176]

Why does maintaining public confidence in banks seem to be of greater concern in Germany and Japan than in the United States? In Germany, it may reflect the importance of bank lending relationships to the industrial sector. In Japan, cultural differences and attitudes toward business failure may also play a role.[177]

These factors have little to do with the actual mix of powers available to banks. This suggests that expanding United States bank powers will not necessarily expand the government's role in failure prevention. The United States financial markets have tolerated the failure of diversified securities organizations such as Drexel Burnham.[178] In the past, they have tolerated bailouts

175. *See supra* text accompanying notes 146-49 (Germany) & 160 (Japan).

176. One difference between the German and Japanese banking systems should be noted. In Japan, central bank policy reflects government policy. The Bank of Japan acts as an administrative extension of the MOF. *GAO Study*, *supra* note 2, at 27. In Germany, the Bundesbank is (at least theoretically) independent from political forces. Nevertheless, banking stability has been a priority in Germany for both the central bank and the government. Both the Bundesbank and the government's Federal Banking Supervisory Office are involved in bank oversight and coordinated rescue efforts. *GAO Study*, *supra* note 2, at 15.

177. Active bank support policies are favored by most European governments, for one or both of the reasons identified here. As this paper was being written, the government of Sweden was contemplating some form of public recapitalization or financial support for its troubled banking industry. Swedish Ministry of Finance, Statement by the Minister for Fiscal and Financial Affairs (Sept. 24, 1992) (on file with the *Brooklyn Journal of International Law*). The Swedish example provides further support for two points made in this paper. First, universal banking powers do not entirely insulate banks from financial distress. Second, in most non-U.S. banking systems, preserving international confidence in the banking system is a matter of national economic policy, providing the justification for failure prevention.

178. In Drexel's case, government regulators did act to ensure that the firm's liqui-

of banks mainly to protect the deposit insurance fund from even greater losses. Most admirers of universal banking systems have no desire to emulate the activist failure prevention policies of nations like Germany and Japan.[179]

V. CONCLUSION

Most of our economic rivals have universal banking systems. Most of these systems have experienced fewer bank failures than ours. Does this mean that the universal banking model is inherently more stable than our own?

At a time when quick fixes to banking problems are in demand, it is tempting to say yes and to advocate bank diversification as the solution to the banking crisis. The story, as usual, is more complex. The apparent stability of universal banking systems is more closely tied to local capital market structures and government policies than to the mix of financial products available from banks. Simply giving United States banks more powers will not produce an American version of the German "*Grossbanken.*" It may merely lead to a shift in the relative fortunes of

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dation occurred in an orderly fashion so as to minimize customer losses. Nevertheless, the government did not deem it necessary to keep Drexel alive as a going concern despite the probable adverse effect of its demise on the junk bond market that Drexel had virtually created and still dominated. *See Wall St. Era Ends as Drexel Burnham Decides to Liquidate*, WALL ST. J., Feb. 14, 1990, at A1. In fact, Drexel's failure did shake public confidence in the junk bond market, causing serious dislocations for companies and investors that had relied on the continued stability of this market. But there was no significant spillover effect on other funding markets in which Drexel was not a major player. Competitive, fragmented financial markets meant that the financial system as a whole could survive the loss of even a large financial intermediary.

179. Although fragmented financial markets may give us the luxury of being able to tolerate the failure of even a large financial intermediary, there is one cost worth considering. Government support policies affect debt ratings, and debt ratings affect banks' ability to compete for capital. Recently, U.S. money market funds have not been able to invest in some U.S. banks because these banks' credit ratings are too low to meet the minimum legal investment standards mandated by the Securities and Exchange Commission that limit money market funds to high quality debt securities. *See* 17 C.F.R. § 240.2a-7 (1992). Because of government support policies, non-U.S. banks may be able to hold onto their high ratings and enjoy a funding advantage in the U.S. money markets. (For example, the perception that the Japanese government will never let a major bank fail may put a floor under the ratings slide that has been experienced by Japanese banks as their financial condition has deteriorated. *See supra* text accompanying note 161.) This is not a problem for those U.S. banks that have been able to signal their credit quality to the international markets, but it does affect weaker banks, raising questions as to whether they can raise enough new capital to take advantage of universal banking powers. This may be another reason why universal banking powers are not likely to solve the profitability problems currently experienced by so many U.S. banks.

the present players in our highly competitive, fragmented financial markets.

There may be good reasons to permit banks to diversify. One reason is that market realignment has already occurred. Morgan and Bankers Trust are already closer to investment banks than to old-fashioned full-service commercial banks.

There may be different reasons to emulate the banking policies of Europe and Japan which in the past have deliberately encouraged stability over competition in financial markets. Before we wish for the harmony of other banking systems, however, it is worth noting that many universal bankers envy the vibrancy of our own capital markets. In fact, the trend in universal banking markets seems to be toward increased competition and the breakup of traditional oligopolies, as suggested by developments in Japan and in the integrated European market.

Ironically, in global markets, a new version of the universal bank may be prevailing — the highly competitive capital market specialist that more closely resembles the United States hybrid than the traditional universal banks of Europe. This universal bank may not enjoy the stable earnings and capital market insulation of its predecessor, which benefited from underdeveloped securities markets and a bank-dominated credit system. Nevertheless, this new universal bank is better positioned to compete in rapidly changing financial markets, offering a package of sophisticated products that satisfy growing customer demand for better financial services. As we look to Europe for a model of expanded bank powers, European banks may be looking to our successful universal banks for examples of how to carve a niche in fiercely competitive international financial markets.