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Geoffrey P. Miller

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COMMENT ON UNIVERSAL BANKING AND FINANCIAL STABILITY

*Geoffrey P. Miller**

Professor Helen Garten's thoughtful analysis of universal banking and financial stability observes that it is far from easy, and probably mistaken, to draw the conclusion that the European and Japanese experiences with expanded banking powers will instantly replicate in the United States if banks in this country are given enhanced powers along the model of Germany or Japan. At the same time, Professor Garten is not so skeptical about comparative analysis as to conclude that no meaningful lessons can be drawn from the foreign experience. She does not hesitate to draw appropriate inferences from the evidence, although always with caution about the problems of comparison. Professor Garten's paper can be recommended, therefore, as an epitome of careful comparative work. Although she is not a professional comparativist, her work can stand up with the best in comparative work on methodological grounds alone.

What conclusions does Professor Garten draw from the evidence she assesses? Her analysis is quite wide-ranging but the two essential points are these: (1) The failure rates in countries with expansive banking powers are *lower* than the failure rates in the United States; and, (2) The *reasons* for the lower failure rates, however, may have little to do with the greater asset and activities powers of banks located in these jurisdictions.

As to the first point, Professor Garten is surely correct that failure rates are lower in our peer group countries that allow banks greater powers, at least considering the experience of the past decade. Whether this observation holds true over a longer period is perhaps somewhat more problematic. It is not immedi-

* Kirkland & Ellis Professor, University of Chicago Law School.

ately clear how one can develop a metric to measure banking stability. The United States banking system looks exceedingly unstable if we examine the past decade (1983-93). However, if we look at the half-century between 1933 and 1983, the picture is not nearly as clearcut; for most of this period the American banking system appears just as stable, or more stable, than its Japanese and European peers, especially when the disruptions of World War II are included. Just as the United States' stability of 1933-83 did not predict the disruptions of the past decade in this country, the past is not necessarily a prologue for other banking systems. We might look back at the Japanese banking system in a few years and wonder how we ever imagined it to be such a paragon of stability, given the high level of troubled loans and stock market losses that have plagued Japanese banks over the past few years. Nevertheless, Professor Garten's general characterization of the United States system as less stable than its peer group systems is probably accurate enough for present purposes.

Turning to the explanations of the relative instability of the United States system, Professor Garten builds both a positive and a negative case for her argument that stability is not necessarily the consequence of expanded bank powers. Professor Garten challenges the idea that the diversification permitted by universal banking will necessarily benefit banks or increase the stability of the system. Activities are not like financial assets in a portfolio: diversification is harder to achieve in the case of activities and may be accompanied by a loss of valuable monitoring that dissipates whatever value the diversification may offer. Positively, Professor Garten argues that the apparently greater stability of universal banking systems, and of other systems in which banks exercise greater asset powers than in the United States, is principally explained by factors other than enhanced powers.

Professor Garten sees the existence of a stable customer base as an important element in European and Japanese systems. She suggests that the existence of close bank-customer relationships creates risk-aversion by all parties and provides major borrowers, which are likely also to be connected to their banks by ties of ownership, with an incentive to rescue failing banks. Professor Garten offers little evidence of borrower rescues, but she is clearly correct that borrowers tend to be more closely linked to their lending banks in Europe and Japan than to banks in the United States.

Moreover, Professor Garten is also persuasive when she argues that the stable customer base in these foreign systems is largely due to the underdevelopment of alternatives to bank financing, such as commercial paper or other directly issued securities. With the development of such markets — a phenomenon that happened earlier in the United States than in Japan and that is still in the early stages in Germany — the system of stable bank-customer relations tends to break down.[1] But this is a function of securities market conditions, not of universal banking.

Professor Garten also stresses the importance of industry structure, observing that the highly decentralized United States system of more than 12,000 commercial banks and several thousand thrift institutions may be less stable than the much more centralized banking markets in Europe and Japan. Professor Garten is on the money in linking stability with industry structure. There is plenty of evidence that the instability of the American banking system is related to the balkanized nature of the American banking industry.[2] The structure of the American banking industry, however, is not a direct function of bank powers.

Finally, Professor Garten emphasizes the importance of regulatory policy, observing that United States bank regulators have traditionally been less aggressive at preventing failures than their European and Japanese counterparts. Again, Professor Garten is probably correct that United States regulators have tended to intervene later in the day than regulators in other industrialized nations — a fact which may be explained by this nation's balkanized banking structure, in which only a few

1. As Litt, Macey, Rubin and I demonstrate in another work, when the Ministry of Finance allowed the introduction of commercial paper market in Japan, the so-called "stable" bank customer base quickly evaporated as borrowers sought out the best deals and played one bank off against the other. *See* 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 (1990).

2. A seminal scholar in this field is Charles W. Calomiris, whose historical research indicates that banks in American states which prohibited branching were significantly less stable, on average, than banks which allowed branching. *See* Charles W. Calomiris, *Regulation, Industrial Structure, and Stability in U.S. Banking: An Historical Perspective*, *in* STRUCTURAL CHANGE IN BANKING 19 (M. Klausner & L. White eds., 1993). For a survey of some of the literature on the relationship between stability and industry structure, see Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992).

institutions were considered "too big to fail." Again, however, these differences in regulatory philosophy are not a function of bank powers.

Professor Garten's paper provides an important corrective to those who might conclude, from inadequate evidence, that the key to European-style stability is to permit United States banks to engage in European-style activities. Her paper thus could be taken as counseling against the introduction of universal banking into United States banking markets. However, Professor Garten's paper does not, in fact, address the general case for or against universal banking.

Professor Garten therefore raises, but does not answer, the fundamental question: *Should* the United States regulatory system move in the direction of universal banking by allowing American banks greater asset and activities powers?

In my view, the evidence cited by Professor Garten does not impeach the case for wide-ranging liberalization of United States bank powers. Remember that a rule allowing universal banking would not ipso facto change anything about United States banking structure. *That* would only happen if United States banks themselves decided to place their capital and assets in a venture other than banking. Facilitating universal banking would merely introduce a market test: Banks would enter new product lines only if they saw these activities as sufficiently attractive to justify the risks involved and would stay in these new lines only if the activities proved to be profitable in the long run.

Our limited experience with bank securities powers suggests that the vast majority of United States banks would not make use of these expanded powers at all. Only a very few banks are large or sophisticated enough in the securities business to enter these markets for the long haul. The risks of an experiment with universal banking are, accordingly, not as great as might be imagined.

It is true that universal banking will not be a panacea for problems of instability or low profitability in the industry today. But this only suggests that we should do more to address these problems directly, not that we should place roadblocks in the path of expanded bank powers.

Whether or not we allow universal banking, by all means, let us work toward reasonable policies calculated to increase the competitiveness and health of the United States banking system. While this is not the place to articulate a program for meaningful banking reform, at least three useful measures can be recommended.

First, Professor Garten mentions that bank stockholders do not actively monitor their banks. In the days before deposit insurance, however, banks in the United States operated under a system of double liability: If a bank failed, the bank's shareholders would be assessed an amount up to the par value of their stock for the benefit of the bank's creditors, including depositors.[3] This system gave bank shareholders good reason to monitor their banks and to become risk-averse at exactly the point where the bank got into trouble. Double-liability enlisted bank shareholders as effective risk-monitors while, at the same time, it avoided the problem of excessive risk-aversion that might be introduced by relying on debt-holders as monitors. Although it is too late in the day to return to the old system of double-liability, it would be useful for banking regulators to consider awarding special credit under the capital adequacy guidelines for banks that issue some type of assessable stock to sophisticated investors.

Second, our system of deposit insurance is surely a prime culprit in the instability of the American banking system over the past few years. As is by now well understood, deposit insurance tends to reward risk-takers and to penalize sound bank management. Although some useful reforms of deposit insurance have been implemented — risk-based insurance premia and early closure requirements being the prime examples — these reforms are themselves potentially costly. Much more fundamental reform is indicated if we are to enable the American banking system to recover from the catastrophes of past years and emerge as a stable and powerful competitor on the world stage. Ironically, the banking system was arguably safer without deposit insurance; although many banks failed during the era before deposit insurance, the losses to depositors from bank failure were very, very small.[4] We should drastically cut back on the federal deposit insurance guarantee and subject banks and their managers to the discipline of the marketplace, while at the same time offering a safe transaction vehicle and a small-savers ac-

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3. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

4. *See* Macey & Miller, *supra* note 3, at 59 (average annual losses to depositors from failures of national banks equalled only 44 cents per one thousand dollars of deposit between 1865 and 1934).

count for individuals.[5]

Third, it is time to jettison the preposterously outmoded system of geographic restrictions that have fractured the United States banking industry into so many thousands of firms. Let us now permit unlimited, nationwide branching. Congress came close to doing so last year but the legislation was derailed at the last minute. Other than deposit insurance reform, nationwide branch banking would arguably be the single most valuable measure for increasing the stability as well as the efficiency of the United States banking system.[6]

Professor Garten does not necessarily disagree with all these recommendations, some of which seem indicated by the evidence she herself cites. If these or similar reforms could be implemented, then universal banking would probably not be de-stabilizing for the United States banking industry. While its effects would probably be fairly minor, at least in the short run, universal banking might well offer benefits to bankers, consumers of banking services, and the American economic system.

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5. In fact, some of the better managed banks have good reason to question the value of deposit insurance, given the roughly seven-fold increase in deposit insurance premiums over the past few years. *See* Jonathan R. Macey & Geoffrey P. Miller, *Non-deposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237, 239-43 (1992). If given the opportunity to opt out of federal deposit insurance, some banks would seriously consider doing so. Indeed, if permitted by state law, banks can already opt out of federal deposit insurance, and if they do, they can also avoid a host of other burdensome federal regulations. As Jonathan Macey and I demonstrate in a recent article, by opting out of federal deposit insurance and making certain other changes in its operations, such a bank could become a bona fide universal bank with the full range of securities powers available to non-bank firms. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward Enhanced Consumer Choice in Banking: Uninsured Deposit Facilities as Financial Intermediaries for the 1990s*, 1991 ANN. SURV. AM. L. 865 (1992). Such a bank, moreover, could be owned by any firm, even one engaged in ordinary commercial enterprises.

6. For debate on the desirability of nationwide branch banking, *compare* Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992) *with* Arthur E. Wilmarth, Jr., *Too Big To Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957 (1992) *and* Arthur E. Wilmarth, Jr., *The Potential Risks of Nationwide Consolidation in the Banking Industry: A Reply to Professor Miller*, 77 IOWA L. REV. 1133 (1992).