Brooklyn Journal of International Law

Volume 19
Issue 1
SYMPOSIUM:
Global Trends Toward Universal Banking:
Comparative Bank Regulation/Meeting The
Regulatory Challenge

Article 9

9-1-1993

The Inevitability of Universal Banking

Jonathan R. Macey

ARTICLE

THE INEVITABILITY OF UNIVERSAL BANKING

*Jonathan R. Macey**

I. INTRODUCTION

The term "universal banking" means different things to different people. But at bottom, everyone agrees that universal banking means expanded powers for banks.

In most discussions of universal banking, Germany typically is cited as the archetypal example of a universal banking regime. In Germany, corporations with banking licenses cannot only take deposits and make loans, but they also are permitted to underwrite and trade securities, to operate mutual funds, to engage in investment counseling, and even to hold large equity shares in commercial, industrial, and insurance companies if these activities are kept within different departments of the bank.[1] In general, the critical difference between German-style universal banking and British-style merchant banking is that it is relatively rare for British banking firms to combine with commercial enterprises, while this is quite common in the German system. In addition, British banks tend to have corporate structures that organize business activities into separate legal subsidiaries, while in Germany all of the various business activities gen-

---

* J. DuPratt White Professor of Law, Cornell University. Prepared for a symposium on Global Trends Toward Universal Banking: A Comparative and Regulatory Analysis, sponsored by Brooklyn Law School, The Brooklyn Journal of International Law and the Brooklyn Law School Center for the Study of International Business Law. I am grateful for comments from Geoff Miller and for the able research assistance of Robert Wray, Cornell Law School class of 1993.

1. STAFF OF HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS NO. 3, 101ST CONG., 2D SESS., AN INTERNATIONAL COMPARISON OF BANKING REGULATORY STRUCTURES 8-10 (Comm. Print 1990).

erally are conducted within the bank itself.[2]

Given the high failure rate of banks in the United States, it is now obvious why the United States government should give our banks expanded powers such as those given to German banks. Financial institutions are engaging in an expanded range of activities, including at least some activities that traditionally have been characterized as "commercial" activities or "investment banking" activities. This Article seeks to explain why the United States should permit bank powers to expand into universal banking by showing that: (1) the differences between the business of commercial banking and the business of dealing in securities are more a product of regulatory artifact than economic reality; (2) the functional differences between banking and commerce have been greatly overstated; (3) the common perception that securities activities are more closely related to banking than are commercial activities is erroneous; and, (4) technology has eroded regulatory barriers to such an extent that universal banking is already a reality in the United States.

For universal banking to become a legal reality in the United States, at a bare minimum, three regulatory changes must take place. First, the federal government must remove the legal restrictions on bank involvement in securities activities. Second, federal agencies must permit banks to invest in and control businesses that engage in activities that are not related to the financial services industry. And finally, both the federal government and state legislatures must remove existing barriers to interstate expansion.

II. COMPARISONS

A. *The Separation of the Banking Business and the Securities Business*

In the United States, the need to separate the business of commercial banking from the business of investment banking has been a cornerstone of the regulatory culture since the 1930s. Indeed, "the perceived need to separate banking and investment banking was even more firmly entrenched among regulators than the need to separate banking and commerce, due to the widespread belief that the securities affiliates of the nation's com-

---

2. *Id.* at 6-8. Insurance and real estate activities generally are conducted through bank subsidiaries, however.

mercial banks were responsible for the Great Depression."[3]

The separation between the banking and securities businesses is a curious one. Both sorts of enterprises serve as sources of financing for borrowers. Banks traditionally make financing available by making loans. Securities firms traditionally make financing available by selling securities on behalf of customers. Borrowers, of course, like other consumers, care only about price. For borrowers, the cost of borrowing is the net interest cost, including transaction costs and tax considerations. Borrowers are indifferent about whether the money they rent comes in the form of a securities offering or in the form of a bank loan. Thus, from the customer's perspective, it is difficult to describe the difference between investment banking and commercial banking.

One way to distinguish between investment banking and commercial banking is to focus on the differences in the processes by which commercial banks and investment banks provide funding to clients. Traditionally, when investment bankers provide such funding, they raise the funds from third parties through the sale of investment vehicles, like stocks or bonds. By contrast, the usual mechanism through which banks provide funding for third parties is the commercial loan, which involves a direct extension of credit by the bank to the borrower. Thus, investment banks are financial intermediaries who bring investors and borrowers together, while commercial banks traditionally have made direct investments of their own capital to supply funding for borrowers.

Unfortunately, this distinction with regard to capital formation places commercial banks at a profound competitive disadvantage to investment banks. For example, commercial banks need more capital to fund their lending operations than investment banks need to fund their investment banking operations. As regulatory agencies have increased both capital requirements and the severity of penalties for being "undercapitalized,"[4] the cost of making traditional commercial bank loans has increased as well. Commercial banks also are at a competitive disadvan-

3. JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 491 (1992) [hereinafter MACEY & MILLER]; *see also* S. REP. No. 77, 73d Cong., 1st Sess. 8 (1993); 75 CONG. REC. 9887 (1932) (statement of Sen. Glass).

4. *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified throughout 12 U.S.C.); *see infra* notes 29, 35-36, 46 & 50.

tage because investment banks move assets off of their books at a much faster rate than commercial banks, which traditionally have kept loans on their balance sheets as assets until they reached maturity. Thus, commercial banks have greater exposure to both credit risk and interest-rate risk than investment banks. Because commercial banks must be compensated for this additional risk if they are to remain in business, the cost of obtaining financing through commercial lending is generally higher than the cost of obtaining financing by selling securities.

Technological change is another important factor that has placed investment banks in a competitively advantageous position with respect to commercial banks. Advances in technology have decreased the cost of providing funding for business through issuing securities relative to the costs of providing funds through commercial lending. As Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, observed:

> Developments in computer and communications technology have reduced the economic role of commercial banks and enhanced the function of investment banking. These permanent and fundamental changes in the environment for conducting financial business cannot be halted by statutory prohibitions, and the longer the law refuses to recognize that fundamental and permanent changes have occurred, the less relevant it will be as a force for stability and competitive fairness in our financial markets. Attempts to hold the present structure in place will be defeated through the inevitable loopholes that innovation forced by competitive necessity will develop, although there will be heavy costs in terms of competitive fairness and respect for law that are so critical to a safe and sound financial system.[5]

The most important effect of changes in technology has been the facilitation of securitization. Securitization involves the packaging of assets, such as loans, into bundles that are then sold in the form of securities.[6] To the extent that assets can be securitized, the demand for banks' traditional lending activities necessarily decreases because borrowers are able to choose whether to fund their activities through commercial loans from banks or through the issuance of securities. For many borrowers,

---

5. Alan Greenspan, Statement to the Senate Committee on Banking, Housing, and Urban Affairs (Dec. 1, 1987), *in* 74 FED. RES. BULL. 91 (1988).

6. JAMES R. BARTH ET AL., THE FUTURE OF AMERICAN BANKING 62 (1992).

issuing securities can be a low-cost substitute for bank loans. Unable to compete by offering their traditional range of services, banks have tried to compete with non-banks by entering the securitization business themselves. They have met with some success, but the profit margins in this line of business are slim, and it seems clear that the emerging financial services marketplace will not be able to support the huge industrial infrastructure that currently comprises the nation's banking system.

Thus, while securitization is good for the economy generally, because it lowers capital costs and improves the capital allocation process, securitization is very bad for the commercial lending business — and ultimately for commercial banks — because it results in a diminution in demand for commercial loans.[7] The diminution in demand for bank loans has forced banks to enter new lines of business with lower profit margins.[8] Moreover, existing regulatory restrictions on the ability of banks to enter the securities markets has made things even worse by keeping banks out of many profitable lines of business, and by raising the costs to banks of competing in certain areas of commerce and finance.[9]

Moreover, securitization has had a profound effect on the *quality* of assets held by banks. This is because the assets selected for securitization are not selected randomly. Rather, financial institutions securitize only the best assets in a bank's portfolio, a phenomenon generally referred to as "cream-skimming." In particular, economists who have studied the banking industry recognize that bank lending requires that commercial bankers succeed in analyzing non-standardized credit risks and holding such credit risks in their portfolio.[10] In particular, borrowers lie on a continuum, with "information-problematic" borrowers at one end, and borrowers with few information problems at the other end.[11] Some borrowers have such acute information

7. *See* Jonathan R. Macey, Securitization, Its Effect on the Future of Banking (Nov. 21-22, 1991) (unpublished manuscript, on file with the New York University Leonard N. Stern School of Business, Dep't of Economics) [hereinafter Macey, Securitization].

8. *See* Robert E. Litan, *Interstate Banking and Product-Line Freedom: Would Broader Powers Have Helped the Banks?*, 9 YALE J. ON REG. 521, 525 (1992).

9. *See infra* text accompanying notes 21-27 (discussing the regulatory disadvantages faced by banks).

10. *See* ROBERT E. LITAN, THE REVOLUTION IN THE U.S. FINANCE (1991). *See also generally* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 403 (1983).

11. Allen N. Berger & Gregory F. Udell, The Impact of Securitization on the Bank

problems that they are unable to obtain credit from any source, including commercial banks. Other borrowers, those at the other end of the continuum, have few information problems. These borrowers "issue traded securities (along with commercial paper and medium term notes) and are monitored directly (and individually) by the investors who purchase these securities."[12]

In other words, borrowers with relatively serious information problems constitute the clientele of commercial banks, while borrowers with few information problems are eligible for securitization. Thus, one characteristic of assets that are susceptible to securitization is that sufficient public information about them is available so that they can be traded in secondary markets, or at least distributed in an initial private placement or public offering.

Put simply, banks specialize in assessing credit risk. The demand for bankers' skills in evaluating particular investments has declined as secondary, and new issue markets for securities have developed. Geoffrey Miller and I have explained this phenomenon in a previous article:

> The traditional bank loan involves ongoing, continuous monitoring on the part of the bank extending the credit or making the loan. The typical loan document gives banks the right to accelerate the maturity date of their outstanding loans. Banks, seeking to protect their investments, carefully monitor the firms to which they loan money on an ongoing basis. By contrast, the process of securitization involves intense monitoring by the underwriters at the time a block of securities initially is offered to the public. After the securities are sold, however, it is expected that the subsequent monitoring of the issuer will be less intense because of the well-known collective action and free-rider problems facing those who invested in the issuers' securities. In particular, unlike banks, many investors who buy securities will engage in little, if any[,] monitoring of credit because they must incur the full costs of monitoring the issuer, while only capturing a small portion of the gains from such monitoring.
>
> Those firms that cannot obtain credit unless they subject themselves to the continual monitoring performed by banks will continue to seek bank loans. All else being equal, borrow-

Liquidity Problem (Nov. 21-22, 1991) (unpublished manuscript, on file with the New York University Leonard N. Stern School of Business, Dep't of Economics).

12. *Id.*

> ing from a commercial bank will be more costly than raising capital by issuing securities because banks must charge more interest on loans to compensate for the continual monitoring associated with such lending.[13]

Firms that can obtain credit from the securities markets will do so in order to avoid the indirect costs of bank monitoring, which come in the form of higher interest rates charged by banks. Firms that do not need constant monitoring are likely to be better credit risks than firms that need constant monitoring. Consequently, "all else being equal, borrowers that are better credit risks will sell securities rather than borrow from banks because such borrowers will have no desire to pay the higher costs of obtaining the continuous monitoring available through commercial banks."[14]

Another reason why securitization generally is a less costly financing vehicle than bank lending is that investors are willing to pay a premium for liquidity. Liquidity is "a market characteristic that assures investors that they can promptly dispose of or purchase securities at a price reasonably related to the immediately preceding price for that security and to anticipated succeeding prices."[15] Liquidity attracts investors by assuring that securities prices will reflect the firm's true economic value, thereby permitting relatively poorly informed investors to invest without incurring significant information and search costs. Liquidity also is of value to borrowers because it permits them to ascertain readily the cost of incurring new debt. Moreover, increased liquidity lowers borrowing costs by allowing securities to be used as collateral for loans.[16]

Thus, for all these reasons, it is not surprising that commercial banks have made strenuous efforts to enter the securities markets. Regulations that prevent banks from engaging fully in securitization activities have been bad for banks for several reasons. First, as mentioned above, to the extent that banks continue to make commercial loans, they have been forced to concentrate on increasingly risky loans as the better loans become

---

13. Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 WASH. U. L.Q. 769, 774 (1991) [hereinafter Macey & Miller, *America's Banking System*].

14. *Id.*

15. Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 325.

16. *See* SIDNEY ROBBINS, THE SECURITIES MARKETS 33 (1966).

securitized by investment banks.

Second, commercial banks have long had a competitive advantage over other firms at making commercial loans. This competitive advantage stemmed both from the fact that commercial bank officers specialized in developing close relationships with their borrowers, and because the lending function was coupled with the deposit-taking function. Banks' ability to observe their customers' cash flows, as reflected in their deposit and savings accounts, was an invaluable source of information. As borrowers began to fund their activities by issuing securities rather than by taking commercial loans, banks lost more than capital alone:

> The problem was not simply a loss of loan revenues, although this was bad enough. In addition, commercial banks were deprived of key information about the activities of their loan customers. In the days when corporations returned to their banks frequently to roll over commercial loans, banks were able to maintain regular contact with their customers and thus to obtain reliable, current information about them. That source of information began to dry up as blue chip corporations increasingly turned to the commercial paper market for their short-term financing needs.[17]

Third, in those aspects of the securitized world that United States banks are permitted to enter, particularly the commercial paper industry, competition is extremely tough. Moreover, commercial banks have no competitive advantage at securitization. Consequently, banks' market share of originations for loans that can be securitized has been eroded dramatically.[18]

Finally, securitization has been bad for banks because the fees associated with securitizing a loan are trivial compared to the profits involved in booking the loan as an asset. Thus, even where banks are able to securitize their assets, their profit margins still decline.[19] As the assets that were susceptible to monitoring were stripped off of banks' balance sheets and securitized, banks were faced with the following choice: They could either shrink by declining to replace securitized assets with new assets, or they could replace the securitized assets with riskier, lower

---

17. 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, 378 (1990).

18. Macey & Miller, *America's Banking System*, *supra* note 13, at 781.

19. Macey & Miller, *America's Banking System*, *supra* note 13, at 780.

quality assets that were ineligible for securitization.[20] For this reason, the benefits from securitization, which come in the form of the fees they earn from originating, selling, and servicing the loans that comprise the securities, are offset by "much more powerful, and much less appreciated, negative effects on banks . . . ."[21]

B. Results of Separation

The negative impact of securitization on banking business can be amply illustrated with examples from recent events in the banking industry. Perhaps the most powerful illustration of the inroads that securitization has made on the traditional practice of commercial lending is the emergence of the commercial paper market in the United States as the primary source of short-term financing for publicly held corporations during the late 1970s and early 1980s. Large blue-chip corporations, which traditionally had turned to commercial banks for their short-term credit needs, found that they could save money by going directly to the commercial paper market rather than obtaining funds from banks or other financial intermediaries. Banks were unable to compete by offering commercial loans because they were more costly. Therefore, they were forced to try to enter the commercial paper business directly.

Commercial banks also have attempted to lower their costs by securitizing their assets through loan sales. Commercial banks have become increasingly sophisticated at packaging loans for resale. The traditional loan participation still exists, but it has been supplemented by new inventions, particularly "loan strips" and loan strip participations. These loan strips allow banks to avoid the risk and regulatory costs of having loans on their balance sheets while permitting purchasers to obtain debt instruments with short-term maturities.[22]

A loan strip generally involves the sale by a bank of particular portions of a revolving credit agreement. Suppose, for example, a borrower arranges for revolving credit with a particular bank. The borrower borrows and repays money as needed during the period in which the revolving credit agreement was in effect.

---

20. Macey, Securitization, *supra* note 7, at 4.

21. BARTH, *supra* note 6, at 63.

22. *See generally* Banco Espanol de Credito v. Security Pac. Nat'l Bank, 973 F.2d 51 (2d Cir. 1992).

The bank determines the interest charged on the borrowing in a variety of different ways. Sometimes the bank ties the interest rate to the prime rate, other times to the rate at which the bank could fund the advance by purchasing funds in the London interbank market, or in the domestic Certificate of Deposit (CD) market. Banks can then resell the loans that resulted when their customers borrowed some of the funds available in the revolving credit agreement. These loans often have relatively short maturities, despite the fact that the bank does not require its customer, under the terms of the revolving credit agreement, to repay the principal for some time. To make the transaction work, commercial banks generally are committed to refinancing maturing credit agreements on fairly liberal terms. For example, banks do not require borrowers to make representations and warranties that there was no material adverse change in their financial condition or operations in order to receive a rollover of outstanding advances.

These changes in the traditional loan documents created regulatory problems for banks participating in the loan sale markets. These problems arose because regulators required banks to treat their refinancing obligations under committed lines of credit as borrowings for accounting purposes and as deposits for reserve-requirement purposes.[23] However, in December 1990, the Federal Reserve gave the sale of loan strips a considerable boost when it eliminated reserve requirements for net Eurocurrency liabilities and non-personal time deposits.[24]

The economics of the modern market for loan participations was succinctly summarized by Professor Marcia Stigum, who has observed that the sale of loan participations by money center banks "is one manifestation of their commitment to evolve out of old-style banking into investment banking."[25] The purpose of this evolution is to permit banks to "get out of their old make-a-loan-and-distribute-it business."[26]

Professor Stigum's observation describes the attempt commercial banks are making, against the tide of federal regulations, to lower their costs and enter the modern world of finance. Those who disapprove of universal banking and oppose the en-

---

23. 12 C.F.R. § 204.132 (1992); Joseph G. Haubrich, *An Overview of the Market for Loan Sales*, 4 COM. LENDING REV. 39, 46 (1989).
24. 77 FED. RES. BULL. 95 (1991).
25. MARCIA STIGUM, THE MONEY MARKET 1083 (3d ed. 1990).
26. *Id.*

try by banks into the securities business are, in essence, advocating that commercial banks remain in the business of selling buggy whips at a time when the world has turned to the automobile. There is no coherent reason for barring commercial banks from the business of dealing in securities because dealing in securities is simply another means of providing funding for borrowers in need of cash.

The same competitive pressures that affect bank assets also have affected bank liabilities. On the liability side of the balance sheet, banks attract depositors by offering them highly liquid claims. Banks then take these resources and invest them in extremely illiquid investments. The banks ability to convert illiquid investments into liquid investments is, of course, of great value to depositors. But, as in the case of commercial lending, the ability of banks to charge a premium for this service declines as close substitutes emerge. Mutual funds, insurance companies, pension funds, finance companies, and government-sponsored enterprises all substitute for the traditional deposit-taking functions of banks. It is well known that "[t]hese competitors [of banks] have been gradually replacing depositories as individuals have been putting a relatively smaller proportion of their savings into depositories . . . ."[27]

Even securitization itself, which provides investors with the ability to invest directly in liquid assets that provide relatively high rates of return, is one form of substitute for bank deposits. Barth, Brumbaugh, and Litan have observed, "Securitization has increased the number of holders of formerly illiquid loans held almost solely by depositories to include pension funds, insurance companies, mutual funds, and individuals themselves."[28] Of course, these new holders of securitized assets must obtain the funds necessary to purchase these securities. In part, investors acquire these funds by liquidating their depository accounts with banks. Thus, absent the artificial regulatory advantage of deposit insurance, the liability side of banks' balance sheets would be shrinking even faster than it has done already.

III. The Functional Differences Between Banking and Commerce

The purpose of the above discussion was to show that the

27. BARTH, *supra* note 6, at 61.
28. BARTH, *supra* note 6, at 64.

erosion of the prohibition on bank involvement in securities dealing has resulted both from competitive necessity and from the economic reality that the distinction between commercial banking and investment banking is a product of regulatory artifact rather than sound public policy. The purpose of the present discussion is to make the bolder claim that many of these same arguments apply to the traditional distinction between banking and commerce.

The United States government generally prohibits banks from engaging in commercial activities, restricting banks to engaging only in those activities that constitute the "business of banking" or that are "necessary to carry on the business of banking."[29] At first blush, this distinction would seem easy to operationalize. Clearly, there is a difference between banking and commercial activities such as home building or pencil manufacturing. On the other hand, the difference between commercial banking and certain other commercial activities is difficult to detect. When one takes a close look at the banking industry, one finds that information processing is critical to success. Indeed, as Robert Litan has recognized, "all financial service firms are essentially in the same business, providing and transferring information, which suggests the presence of scope economies across the broad range of financial services. A bank is primarily a computer data base that stores information about deposits and loans."[30]

For example, banks that offer to retail stores revolving lines of credit secured by inventory and receivables must be able to determine the status of those receivables and inventory as quickly and accurately as possible. Banks will take transaction data as recorded on magnetic tape placed in cash registers to obtain information about retailers' activities, including sales patterns and payments patterns. Of course, this same information also is of great interest to the retailers themselves. Thus, banks have attempted to enter the business of supplying data processing services to customers for a fee.[31] Under this service, banks supply the technical expertise necessary to assemble and compile reports containing a wide range of information on retailers' businesses. Banks can also use this information in connection

---

29. 12 U.S.C. § 24 (1992). *See also* MACEY & MILLER, *supra* note 3, at 136.

30. ROBERT E. LITAN, WHAT SHOULD BANKS DO? 77 (1987).

31. National Retailers Corp. of Ariz. v. Valley Nat'l Bank, 411 F. Supp. 308 (D. Ariz. 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979).

with evaluating loan applications. But, retailers themselves also could purchase the information, independent of a loan transaction, thus providing the bank with income unrelated to lending activity.

Certainly, it is possible to limit banks' ability to engage in this sort of commercial activity, but it would hardly be rational to do so. For example, in *National Retailers Corp. of Arizona v. Valley National Bank*,[32] which involved a successful lawsuit by a trade group of data processors to bar commercial banks from the business of offering data collection and processing services to retailers, the court held that:

> [I]f the reports available [from the banks' computer-based retail information processing services] were limited to the processing of applications for accounts receivable or operating capital loans by the [defendant bank], this Court would not hesitate to find such activity sufficiently related to the express powers of national banks and within the standard of [the applicable precedents] . . . . However, the facts of this case are otherwise. [The defendant bank] did not limit or intend to limit [its data processing services] to producing information and reports useful in processing and considering loan applications from persons or businesses participating in the [data processing program].[33]

This opinion, like the general, blanket legal prohibition on mixing banking and commerce upon which it is based, ignores economic reality. Banking is an industry based on information. Banks must have the ability to access and manipulate data on customers' accounts, loan interest rates and other pertinent information.[34] Because banks must obtain accurate data to survive, to prohibit banks from using that data in as many commercially viable ways as possible raises costs artificially. Such regulations not only harm consumers by depriving them of services at the lowest possible price, but also harm banks by raising their costs of doing business.

Moreover, the information retrieval and data-processing businesses are characterized by high fixed costs and low marginal costs. Once a bank has made the investments in hardware, software, and training to perform the data-processing services

---

32. *Id.*
33. *Id.* at 315.
34. MACEY & MILLER, *supra* note 3, at 156.

that it needs, it can offer the excess capacity on its system at low cost. Since performing data-processing services is essential to modern banking, offering excess capacity to third parties clearly seems to be appropriate economically, if not legally.

Federal regulatory agencies also prohibit banks from providing insurance. The "turf wars" between the insurance industry and the banking industry over whether banks can offer insurance services are legendary. The skills and technology necessary to succeed in the insurance industry are virtually identical to the skills and technology necessary to succeed in banking. However, the insurance industry has been remarkably successful in keeping banks out of the insurance industry, regardless of the obvious ease and efficiency with which banks could enter this business. This success has harmed banks enormously. The rules that prohibit banks from engaging in a full range of insurance services can only be justified on political grounds. They cannot be justified on economic grounds.

It appears clear that, contrary to popular belief, certain commercial activities are in fact just as closely related to banking as securities activities. Thus, just as there is no principled basis upon which to prevent banks from entering the securities business, there is no principled basis upon which to exclude banks from certain aspects of commercial activity.

Current regulations have forced banks to operate inefficiently and to compete in global markets at tremendous competitive disadvantages. The only possible public interest justification for placing banks at such a competitive disadvantage is to protect them from risk. In essence, the argument is that, since bank deposits are federally insured, the government should force banks to accept activities restrictions in exchange for their ability to offer depositors federally insured deposits. But these activities restrictions are an extremely ineffective device for controlling risk. They do not prevent banks from engaging in even riskier activities, like certain types of commercial and sovereign lending. Moreover, activities restrictions also prevent banks from obtaining the benefits of diversification, thus exposing banks to even higher levels of risk.

IV. GEOGRAPHIC RESTRICTIONS ON BANKING

Perhaps reasonable people may disagree about the extent to which the government should allow commercial banks to enter the securities industry. And clearly there are meaningful differences between certain (though not all) types of commercial activities and the business of commercial banking. However, the geographic restrictions on bank expansion appear to be completely nonsensical. No one can seriously contend that the business of banking is different in Maine than in California. Nonetheless, the restrictions on intrastate expansion contained in state law, on interstate branching contained in the McFadden Act,[35] and on bank holding company (BHC) acquisitions across state lines contained in the Douglas Amendments to the Bank Holding Company Act (BHCA),[36] continue to make geographic expansion difficult, despite the significant inroads on these restrictions that have occurred in recent years.

Furthermore, the legal constraints on geographic expansion also raise the costs of commercial banking services. Such rules are inefficient both because they prevent banks from achieving economies of scale and scope in their operations, and because they prevent banks from obtaining the benefits of diversification.

It is easy to explain how banks would benefit from the diversification made possible through geographic expansion. Such expansion would allow banks to expand their deposit bases as well as their loan portfolios. Geographic expansion also would enable banks to diversify more easily among different types of borrowers. For example, certain types of businesses such as automobile manufacturing, chemical producing, and insurance underwriting tend to be quite large. Lending limits prevent all but the largest banks from making loans to these types of industries. This forces small banks to focus their lending on small, usually local, borrowers, thus excluding them from a potentially more lucrative transaction.[37]

The cost savings to banks in the form of economies of scale of operations is more difficult to specify. Some have argued that geographic expansion is unnecessary because studies have not demonstrated that economies of scale in the form of lower average costs can be obtained when banks expand. However, these studies are unconvincing for several reasons. First, as noted above, technological improvements often come in the form of information systems with large initial fixed capital costs followed

35. 12 U.S.C. § 36(c) (1992).
36. 12 U.S.C. § 1842(d) (1992).
37. LITAN, *supra* note 30, at 40.

by negligible marginal costs for additional applications. To the extent that banks can expand geographically, they can spread the costs of new technology across a wider array of applications. Second, many regulatory costs, which constitute a large portion of the cost of doing business for commercial banks, are fixed, and therefore result in lower average costs for larger banks. Third, as Professor Litan has observed, the studies of scale economies in banking only examine smaller banks (*i.e.*, those with less than one billion dollars in assets). By contrast, studies that have looked at scale economies of large Japanese banks with over one billion dollars in assets have found substantial economies of scale.[38]

Finally, and most importantly, the world of universal banking provides a useful natural experiment for those interested in whether there are economies of scale in banking. In large industrialized countries like Germany and Japan, where legal constraints have not impeded bank expansion, the Darwinian process of economic competition has produced an equilibrium condition in which large banks dominate.

V. Implications and Observations

The purpose of the preceding discussion has been to argue that none of the existing restrictions on universal banking can be defended on principled economic grounds.[39] The following discussion explores the principal implications of that conclusion.

A. *The Economics of the Politics: Prospects for Reform*

The only reason that universal banking has been formally adopted in the United States is because well-galvanized special-interest groups have succeeded in blocking the efforts of commercial banks to gain entry onto their turf. For example, the insurance industry has, by and large, kept the banks out of the insurance business. Similarly, the securities industry has kept the banks out of the underwriting and trading of debt and equity for the past sixty years. The regional bankers have kept ex-

38. Litan, *supra* note 30, at 40.

39. It also has been argued that banks must endure activities restrictions for antitrust reasons. This argument is without foundation. The antitrust laws apply to the banking industry just as they apply to other industries. There is no reason why these laws are not sufficient to protect the public from any dangers associated with cartelization or other monopoly behavior by banks.

pansion-minded banks from gaining the ability to engage in interstate banking. It is important to note that, contrary to popular belief, the prospects for reform are declining rather than improving over time, despite the recent and well-publicized efforts of the Bush Administration to reduce geographic restrictions and to expand banks' securities powers.[40]

It also should be noted that Congress defeated every aspect of expanded powers contained in the Treasury Department's failed reform efforts. The legislation that Congress ultimately passed, the Federal Deposit Insurance Corporation Improvement Act of 1991,[41] placed banks in a significantly weaker economic position. Not only did banks fail to receive relief from restrictions on geographic expansion and from restrictions on their ability to deal in securities, but Congress placed new restrictions on their insurance powers. Additionally, banks' operating costs dramatically increased, both as a result of new capital requirements contained in the statute and as a result of higher premiums for deposit insurance.[42]

Public choice theory suggests a reason why banks recently have been treated with hostility in the political arena. The public choice model of government decision making begins with the assumption that legal rules, including regulations promulgated by administrative agencies, are devised to provide private goods, in the form of wealth transfers, to powerful interest group constituencies. In this context, banking law is a commodity and, like other commodities, it is "demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social wel-

40. For example, section 262 of the Financial Institutions Safety and Consumer Choice Act of 1991 (FISCCA), H.R. 1505, S. 713, 102d Cong., 1st Sess. § 103(a)(1)(c) (1991) would have amended the McFadden Act by permitting interstate branching by national banks within three years, or at the time the state of the proposed branch had permitted interstate banking by bank holding companies. FISCCA would have also amended the Glass-Steagall Act to permit Financial Services Holding Companies (basically any company controlling a bank) to engage in a full range of securities activities through a separate, authorized subsidiary. FISCCA, § 203(a)(3)(c).

41. Federal Deposit Insurance Corporation Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified in scattered sections of 5 U.S.C., 12 U.S.C. & 15 U.S.C.) (1991) (FDICIA).

42. Under one provision of the FDICIA, Congress instructed the FDIC to implement a system of risk-adjusted deposit insurance premiums. *See* 12 U.S.C. § 1817(b)(1)(A) (1988). Also, if a bank's capital falls below a certain level, the bank must produce a detailed plan outlining how it would restore its capital base to a satisfactory level. 12 U.S.C. § 1831o (1988).

fare . . . ."[43]

However, as in economics generally, the way that one determines the value of a particular piece of legislation to a particular group is by how much that group is willing to pay for it. This, in turn, necessarily reflects the groups' ability to pay. Congress uses "taxes, subsidies, regulations, and other political instruments . . . to raise the welfare of more influential pressure groups. Groups compete within the context of rules that translate expenditures for political pressure into political influence and access to political resources."[44] As I have noted in another context, the public choice model holds that:

> [P]oliticians maximize the aggregate political support they receive from all interest groups. At the margin, a legislature will alter a rule if the resulting gain in political support from some group outweighs any expected loss in support from a rival group. Thus, contrary to popular belief, the public choice model is, in fact, inconsistent with the rather primitive "capture theory" of economic regulation which posits that one particular interest group rather than a group of interest groups drives legislation or regulation. Competition among rival pressure groups with drastically differing views about what the legal landscape ought to look like leads to legislative compromise, not because the compromise is in the public interest, but because it is the most effective strategy politicians have for maximizing political support. This is because politicians can please certain of these groups only by alienating others, and will attempt to customize law to maximize the total support they receive by alienating as few groups as possible.[45]

The ramifications of public choice theory for the banking industry seem clear in light of the foregoing discussion. The banking industry is getting weaker. Other industries are becoming stronger. As a consequence, the ability of the banking industry to amass the economic resources necessary to succeed in the political arena is declining.

As effective, low-cost substitutes have arisen for the core banking services of lending and deposit-taking, other industries,

---

43. Robert A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982).

44. Gary S. Becker, *Pressure Groups and Political Behavior*, *in* CAPITALISM AND DEMOCRACY, SCHUMPETER REVISITED 120, 124 (1985).

45. Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 CORNELL L. REV. 43, 46 (1988).

such as insurance and investment banking, have obtained access to economic resources, which they have used effectively in the political arena. The political cause of the banking industry has not been helped by the fact that it often is divided in its views on various policy issues. Regional banks are opposed to interstate expansion and indifferent, if not outright hostile, to the idea of expanded securities powers. Money center banks obviously have opposing views.

Clearly, declining industries often are able to obtain political support. In particular, as David Friedman has trenchantly observed, where a declining industry such as steel or agriculture has a large portion of its wealth tied up in fixed assets that are in short supply, such as steel mills or farm land, it will benefit even a declining industry to pay for protectionist legislation.[46] In contrast, the assets devoted to the banking industry are not fixed. Deposits and loans, and even the computers and buildings that currently are devoted to banking, can readily be shifted to other uses. Even the human capital skills of bankers are fairly generic. The skills that are useful in evaluating a business for purposes of making a commercial loan also are useful in doing due diligence for purposes of a securities offering, or evaluating an insurance risk.

B. Universal Banking

In the beginning of this paper, I argue that universal banking is not only desirable, it is inevitable. This assertion might seem dubious in light of the preceding discussion, focusing as it has on the declining political power of the banking industry. However, if one takes seriously the arguments about the interchangeability of banking and other industries, it seems clear that universal banking is fast approaching and, in fact, may already have arrived. The only problem is that, in the United States, our universal banks are not legally known as "banks." They are known by other names like Fidelity Investments, Merrill Lynch, Ford Motor Company, and Sears, Roebuck and Company. These firms offer depository banking services in the form of money market accounts and ownership of non-bank banks and unitary thrifts that are perfect economic substitutes for the depository services offered by commercial banks. Similarly,

46. DAVID D. FRIEDMAN, PRICE THEORY: AN INTERMEDIATE TEXT 549-50 (2d ed. 1990).

these firms offer a full range of other services including retailing, securities brokerage, securities underwriting, real estate brokerage, insurance underwriting, and consumer lending.

C. Problems with the Current Model: Mandated Inefficiency

A central problem with the current regulatory system generally has gone unrecognized in the literature. This problem is not simply that the pace of change is coming too slowly, although that is clearly the case. The problem is not even the enormous cost of change, in the form of lobbying costs and litigation costs, although this too clearly is true. Rather, the problem is that when regulatory change does occur, it inevitably occurs in ways that place banks at an economic disadvantage vis-à-vis their rival competitors who are offering the same services.

For example, after decades of litigation, which included two Supreme Court opinions and several agency rulings and lower court cases,[47] commercial banking organizations finally were given the opportunity to enter the field of selling commercial paper.[48] Unfortunately, when permission finally came for banks to enter this field directly, it came with such severe restrictions that banks could not compete. Unlike investment banks that could purchase commercial paper from issuers and then resell it to investors in a firm-commitment underwriting, banks could only agree to try to sell commercial paper as agents, without purchasing for their own account any of the commercial paper it placed.[49] While this method of selling commercial paper satisfied the statutory requirement that commercial banks sales of securities be consummated "without recourse and solely upon the order and for the account of customers,"[50] it left commercial banks at a significant competitive disadvantage vis-à-vis their investment banking rivals, who could guarantee to issuers that they would be able to raise necessary funds by selling commercial paper.

It is telling that those commercial banking companies that

---

47. For full procedural history of this very complex and drawn out litigation, see A.G. Becker, Inc. v. Board of Governors of the Fed. Reserve Sys., 519 F. Supp. 602 (D.D.C. 1981), *rev'd* sub nom., 693 F.2d 136 (D.C. Cir. 1982), *rev'd* sub nom., Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 469 U.S. 137 (1984).

48. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

49. *Id.*

50. 12 U.S.C. § 24 (1988).

have gone into the commercial paper business have not done so directly through their banks, but rather have elected to locate their commercial paper operations in non-banking affiliates within the holding company structure in order to avoid the regulatory prohibitions on bank commercial paper operations. This, of course, denies to commercial banks the benefits of diversification and economies of scale associated with entry into the commercial paper business.

Similarly, while the government allowed banks to enter the data-processing business, this privilege was granted only on a heavily restricted basis that did not apply to other non-banking firms. The Federal Reserve Board (the Fed) permitted banks to produce and process information relevant to considering and processing loan applications, but, unlike their non-bank rivals, banks could not put this information to its full economic use.[51] Banks could not, for example, offer data-processing services to retail firms that are not bank customers, or sell excess time on bank data processing equipment to interested third parties, or market by-products of its data processing activities, such as software programs or raw data.

A clear expression of this problem facing banks can be found in *Arnold Tours, Inc. v. Camp*,[52] the seminal case on the proper scope of banking powers, which involved the issue of whether national banks could engage in the travel agency business. In a remarkable opinion which obviously did not overly concern itself with the financial well-being of the banking industry, the court held that:

> [W]hile national banks provide certain agency and informational services, they normally are of a kind which are germane to the financial operations of the bank in the exercise of its express powers. There are of course instances in which banks have, as a convenience to their customers, and without additional compensation, obtained railroad, steamship or airline tickets for such customers, or provided information helpful to such customers in connection with their travels. But incidental good will service of this kind cannot reasonably be equated with the operation of a modern travel agency for profit.[53]

---

51. National Retailers Corp. of Arizona v. Valley Nat'l Bank, 411 F. Supp. 308 (D. Ariz. 1976), *aff'd*, 604 F.2d 32 (9th Cir. 1979).
52. 472 F.2d 427 (1st Cir. 1972).
53. *Id.* at 433.

Thus, banks can conduct travel agency business, but are forbidden to charge for it.

Banking regulations systematically place banks at a competitive disadvantage relative to their competitors at the holding company level as well. The entry of bank holding company affiliates into the commercial paper business was based on the Fed's interpretation of section 20 of the Glass-Steagall Act.[54] While the Fed allowed bank holding company affiliates to deal in commercial paper, it placed severe restrictions on these activities. The Fed decided that holding company affiliates dealing in commercial paper could only sell certain kinds of commercial paper to certain types of investors and in certain minimum denominations. Affiliates could not receive more than five percent of their revenues from such activities, and such affiliates could not account for more than five percent of the total market in dealer-placed commercial paper.[55] While the market share limitation ultimately was struck down as having no basis in the relevant legislation,[56] the other restrictions imposed by the Fed were upheld.[57] And, since these restrictions did not apply to organizations not affiliated with commercial banks within a holding company structure, it is safe to assume that these restrictions have placed commercial bank affiliates at a disadvantage relative to their competitors. Regulating fiat rather than market forces determines the very mix of products sold by bank holding company securities affiliates.

One can make the same argument with respect to the nature of geographic restrictions that prevent banks from expanding. The Douglas Amendment to the BHCA prohibits a bank holding company from acquiring a subsidiary bank in a different state unless the acquired bank's state legislature specifically has authorized such acquisitions.[58] Until recently, state legislatures

---

54. 12 U.S.C. § 377 (1988).

55. 73 FED. RES. BULL. at 484 (1987).

56. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47, 68 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) (stating that "[B]y using the term "engaged principally" Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activity. A market share limitation simply does not further reduce this congressional worry.").

57. The Fed's orders were upheld in three separate opinions: Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47, 68 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988); Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 847 F.2d 890 (D.C. Cir. 1988); and Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 900 F.2d 360 (D.C. Cir. 1990).

58. *See* 12 U.S.C. § 36(c) (1988).

bowed to the will of their state bankers and opposed bank holding companies' interstate acquisitions out of fear of takeover threats from larger banks. However, in the early 1980s, banks began to realize the potential benefits of interstate expansion after concluding that increased competition was inevitable and that strong regional banking centers might be better able to compete in national and international markets against money-center banks. Thus, with political backing from local banks, state legislatures began creating interstate banking compacts in which certain states agreed reciprocally to open their interstate banking markets to each other by lifting the Douglas Amendment bar on interstate banking acquisitions.[59]

This development opened the door to bank expansion through the bank holding company structure. Despite the increased ability of bank holding companies to make interstate acquisitions, it seems clear that regulations still make geographic expansion through the holding company structure more costly than expansion through branching. When banks expand through holding company acquisitions, regulations require that the acquired banks must have separate boards of directors and that the BHC must maintain a separate corporate existence from its subsidiary banks even if the BHC owns 100 percent of the subsidiary's stock.[60] In addition, the acquired banks independently must satisfy minimum capital requirements, must have separate accounting and bookkeeping, and cannot take full advantage of the reputational capital of other banks within the holding company.[61] Thus, despite the state-led liberalization of rules governing interstate acquisitions by bank holding companies, current federal regulations and the restrictions which they impose continue to foster inefficiency in the means by which geographic expansion is allowed to occur.

The government has placed similar restrictions on bank holding company affiliates' efforts to offer courier and transportation services.[62] Banking organizations can transport data that

---

59. The interstate banking compact is simply an agreement among states to open their interstate banking markets to each other. As of 1991 33 states allowed nationwide banking by bank holding companies, with 21 states permitting entry on a reciprocal basis. The other twelve states had no restrictions. U.S. TREAS. DEP'T MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

60. MACEY & MILLER, *supra* note 3, at 414-15.

61. *See* Michigan National Corp., Order Approving Acquisition of Bank, 64 FED. RES. BULL. 127 (1978).

62. National Courier Ass'n v. Board of Governors of the Fed. Reserve Sys., 516 F.2d

is financially related, but cannot use excess capacity to transport other kinds of data or goods. Permitting bank holding companies engaged in the courier business to transport only financial documents puts bank holding companies at a competitive disadvantage vis-à-vis courier companies that are not affiliated with banks because a client with both financial and non-financial documents presumably will want to hire a single courier to deliver both sorts of documents.

Likewise, in *Association of Data Processing Services Organizations v. Board of Governors of the Federal Reserve System*,[63] when Citicorp asked the Fed for authority for its subsidiary, Citishare, to engage in computer support services with respect to processing data related to banking, finance, and economics, the Fed decided that the data being processed must be financial, banking, or economic, and must be marketed as such. In addition, the Fed required that any hardware being sold must be offered only as part of a larger package that included software designed and marketed for the processing and transmission of financial, banking, or economic data, and that such hardware could not comprise more than thirty percent of the total cost of the package. Again, these restrictions, to the extent they are meaningful at all, place banks at a competitive disadvantage relative to their competitors.

VI. Conclusion

The upheaval in the banking industry over the past two decades has been, to a very large extent, the result of technological change that caused banking organizations to face vigorous competition from a wide variety of sources. Banks were unable to respond to these new competitive pressures because of the laws restricting universal banking. The ineluctable economic reality is that universal banking is desirable to take advantage of the efficiencies to be gained from combining lending and deposit-taking with data processing, insurance, real estate, and a host of other activities.

The outcome of the interplay between economics and politics in the banking industry is to make United States commercial banks increasingly marginal. As commercial banking has become less important in economic terms, it has been unable to defend

1229 (D.C. Cir. 1975).

63. 745 F.2d 677 (D.C. Cir. 1984).

its political interests before Congress and administrative agencies. The result has been a downward spiral in which the banking industry has become increasingly obsolete. The ultimate irony is that as universal banking, in the form of diversified financial services companies, gradually has emerged in the United States, the nation's commercial banks have become ineffectual wards of the state.