Universal Banking, US Banking Reform and Financial Competition in the EEC[1]

1. Introduction

The German financial system has become the subject of increasing attention by economists and policy makers in both Europe and the United States. The process of economic and monetary unification initiated with the implementation of the Single Market Act and in prospect of a European Monetary Union is expected to increase competition in EEC financial markets. Since financial institutions will be subject to the principles of mutual recognition and home country regulation, except in the case of prudential controls, competition will also involve national systems of regulation. It is generally assumed that market efficiency is greater the lower the extent of market regulation. On these grounds the German financial system, characterised by "universal" banking with unrestricted entry into all types of financial market, is expected to become the dominant form which will force other countries to introduce similar national regulatory systems or face the prospect of their financial institutions emigrating to Germany to be able to compete on an equal basis with German banks.

In the United States, difficulties in the commercial banking system have quickly followed the crisis of the savings and loans banks. The problems facing the commercial banks are generally believed to be the result of financial market legislation which currently allows

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non-deposit-taking investment banks to compete in areas such as commercial lending and transactions services which have traditionally been restricted to deposit-taking commercial banks, while preventing the banks from entering those markets, such as underwriting and securities dealing, which have been, and remain, the preserve of investment banks. Since a "universal bank" may engage in both retail deposit-taking and the financing of industry through underwriting, brokerage, and ownership of financial and corporate debt and equity, the unrestricted German system has been suggested[2] as an alternative to the "segmented" US financial system. Support for the unification of banking and finance is also found in some recent studies which suggest that universal bank systems may provide lower capital costs to industry,[3] and thus offer national competitive advantages to those countries who do not impose segmentation.

Critics of "universal" banking have suggested that financial institutions free to operate in all financial markets would present substantial risks of conflicts of interest and fail to provide sufficient investor protection. This might occur, for example, when a bank who is a major short-term lender to a company becomes responsible for advising the company on the issue and pricing of securities which the bank is also responsible for placing with buyers who may also be among its brokerage or trust clients, and which the bank may also buy or sell for its own proprietary trading account. While it is not impossible that the different sections or subsidiaries of a single institution should act in the best interests of its industrial client, its private and trust clients, as well as its own shareholders, the "universal" banking system does nevertheless create a potential conflict of interest between the banks and its various clients which opens a possibility for abuse which is absent by definition in a segmented system.

In addition, active participation in underwriting or proprietary trading may lead banks to take investment risks which are incompatible with their role as deposit-takers and thus as part of a national payments system. In financial systems which operate with implicit government guarantees, explicit deposit insurance, or with central banks charged to provide lender of last resort lending support, this

[2] See for example the statements by the President of the Federal Reserve Bank of New York in the summer 1989 and spring 1991 numbers of the FEDERAL RESERVE BANK OF NEW YORK's *Quarterly Review*.

[3] See MCCAULEY and ZIMMER, and ZIMMER and MCCAULEY.

means that some of the increased risk will be borne by the general public. This is the "free rider" problem which emerges (as it has in the US) when government explicitly or implicitly guarantees deposit liabilities of private banks used as public means of payment without exercising detailed prudential control over the level of risk associated with the investments which the bank may undertake with the funds raised by offering guaranteed deposits.

Despite these risks inherent in a unified system, the German financial system appears to have been at least as, if not more, stable than more highly regulated systems, such as in the US, which are based upon strict regulation of market segmentation. The present paper suggests that the success of the German system has less to do with the freedom granted to universal banks,[4] than with the alternative approach to bank regulation and supervision which in certain respects is as restrictive as market segmentation. This has allowed the German system to maintain a pattern of specialisation among financial institutions, as well as a particular distribution of securities ownership between firms, banks and the public.

The Legacy of the 1920s Great Crash and the 1930s Great Slump

The US Response

Before the crisis of the 1920s the US financial system resembled the then more advanced European financial centres with widespread operation of what are now called universal banks. The response to the "Great Crash" of 1929 and the subsequent series of bank failures, culminating in the "Bank Holiday" of 1933, was embodied in the 1933 Glass Banking Act and the Securities Act of 1933, the Securities and Exchange Act of 1934 and the 1935 Banking Act. This legislation limited financial institutions to operations in segmented markets, defined in terms of the financial "products" traded in them, subject to

[4] It is not intended to give a full representation of the German financial system. Excellent presentations are available in FRANKE and HUDSON and in Italian in BARZAGHI, 1988 and 1991, and NARDOZZI.

direct governmental or indirect (via self-regulation) regulation.[5] As a result, the possibility of "universal" banks operating simultaneously in a number of different financial markets was eliminated. It also meant that the US conception of financial market "deregulation" was viewed in terms of freedom of access to different market segments.

The immediate intention of the New Deal legislation, under the pressure of the inauguration day bank holiday,[6] was to restore confidence in the collapsing banking system. This aim was pursued by the creation of a Federal Agency[7] to insure deposits (introduced in the 1933 Banking Act and made permanent in 1935). To prevent the fraudulent activity which had occurred during the boom of the 1920s Federal Reserve Board regulation Q limited bank competition for deposits via price competition,[8] and removed the possibility for banks to use deposits to fund speculative activity by severely limiting the assets against which they could legally lend and forbidding underwriting, ownership and secondary trading and brokerage of corporate securities. In addition, the two Securities Acts strictly regulated the financial viability of underwriters and brokers, as well as regulating the financial viability of the companies issuing liabilities and requiring them to issue full financial information concerning their conditions. It

[5] It also meant that financial institutions could not follow synergies in their activity because they were restricted by regulations defined in terms of financial products while markets were increasingly forming around the purchase and sale of "risk"; thus regulations tended to cut across the economic boundaries of the new markets which were developing.

[6] Franklin Roosevelt's first act as president after his inauguration in March 1933 was the declaration of a "bank holiday" closing all banks in the banking system. Bank failures for the post-Crash period were:

1930: 1,350; 1931: 2,293; 1932: 1,453; 1933: 4,000; 1934: 57.

[7] Most accounts point to the fall in bank failures to 57 in 1934 as evidence of the success of the deposit insurance program. But the Glass Act was not passed until June and its deposit insurance provisions did not come into operation until the beginning of 1934, leaving unexplained how the banks survived from March to December – the answer is a piece of Hoover legislation, the Reconstruction Finance Corporation which had been supporting banks from February 1932 (Bank of America) and provided the capital necessary to reorganise the balance sheets of the banks which emerged from the bank holiday by direct purchase of, or lending against, preferred stock or capital notes of commercial bank and trust companies, authorised by an emergency bill passed on March 9. See JONES, pp. 17-87. The RFC thus became the owner of substantial interests in class C banks, the weakest banks which were allowed to reopen. As Jones points out, "This program of putting capital into banks prevented the failure of our whole credit system. It was carried out without loss to the government or the taxpayer" (JONES, p. 26).

[8] It has also been suggested that the preclusion of payment of interest on deposits was to offset the cost of insurance premiums which were one-half of one percent of the banks' deposit liabilities. The magnitudes do not seem comparable.

thus excluded potentially weak or fraudulent financial and industrial companies from the capital market, and required those who were admitted to provide full information to potential investors.

The response to the crisis thus provided for recapitalisation of the banks, provision of blanket federal insurance for their deposits up to $5,000, but imposed restrictions on bank competition for funds via price, as well as restricting the destination of those funds to short-term commercial lending or government securities. Restrictions were also placed on both the issue of new securities and the trading of securities in capital markets to prevent fraud. These actions preserved the banking system, but did little to create incentives to increase the flow of long-term lending to firms or the efficiency of the allocation of funds to industrial borrowers. This task was eventually taken on by the Reconstruction Finance Corporation which became the *de facto* source of long-term funding of private industry during the depression, and virtually replaced capital markets.[9]

The German Response

The German response to the financial crises of the 1930s is perhaps less well-known and the fact that the universal form of banking, which was born in the 1850s,[10] was preserved rather than abolished, as in the US, has led to the idea that the German system is relatively less regulated and thus more prone to the risks believed to be inherent in permitting banks to finance long-term capital market investments with short-term deposit funds. In difference from the US, the German banking crisis of the 1930s was not primarily the result of fraud or the use of deposit funds for speculation in capital markets.

[9] For those convinced by Kindleberger's representation of the Reconstruction Finance Corporation as the US equivalent of the Italian IRI, one should recall that IRI was a holding company created to receive the equity of (usually failed) corporations removed from failing banks' balance sheets, while the RFC was operated as if it were a commercial bank, generally limiting lending to good collateral; IRI could not make Jesse Jones's statement that it had not lost the government or the taxpayer any money!

[10] As Barrett Whale points out, these Kreditbanks did not initially accept public deposits, but were similar to investment partnerships which only put its partners' capital at risk. They generally lent money to small or newly formed initiatives in the hopes of recouping the investment with a profit when they floated their equity in the companies on the capital market. Deutsche was the exception to this general practice. Only after the crisis of 1873 did these banks actively seek deposit funds, partially through absorption of failed banks.

It was the result of hyperinflation in the inter-war period and the extensive reliance on foreign borrowing to finance war reparations. The crisis was set off by an outflow of foreign and domestic funds caused by contagion from the collapse of the Creditanstalt[11] and a run on the Danat Bank[12] after the announcement of the collapse of one of its largest clients led to a bank holiday in July 1931.

In response to the crisis the German government created the Akzept- und Garantiebank to provide the third signatures for bank acceptances which were required in order for them to be discounted by the Reichsbank. As a result of this, and other, rescue operations[13] the German government subsequently came to own 91% of Dresdner Bank, 70% of Commerzbank and 35% of Deutsche Bank. A 1933 government sponsored Banking Enquiry reached the conclusion that there were no structural defects in the banking system and that its organisational form was best left to private initiative, subject only to general overall supervision by the government.

As a result the 1934 German Banking Law (Kreditwesengesetz) created a single supervisory agency with blanket jurisdiction over virtually every aspect of financial activity, aside from insurance. By 1936 the big Berlin "universal" banks had recovered sufficiently to reprivatise themselves and, in difference from the US, the German financial system emerged from the 1930s crisis without any direct government intervention or any major structural changes.

[11] Which had recently merged with the insolvent Boden-Creditanstalt, heavily exposed to industrial borrowers. The French government considered the announcement of the Austro-German Zollverein a *de facto* "Anschluss" of Austria by Germany and a violation of the Treaty of Versailles; this led to rumours, but apparently no more than that, of the withdrawal of funds by French banks from the already weak Creditanstalt and a generalised run on the bank. *Cf.* C.P. KINDLEBERGER, 1987, chapter 7.

[12] The Darmstädter und Nationalbank. The Darmstädter was founded in 1853 as the Bank für Handel und Industrie was the prototype of the "new model" of German banks or Kreditbanken which eventually evolved into the universal bank. *Cf.* P. BARRETT WHALE, p. 9.

[13] Part of which were the famous large public works programs which were initiated in 1932 as pump-priming for private sector investments. When the latter failed to appear military spending provided a ready substitute. The financing of these expenditures was undertaken by some 31 public "central credit institutes" which may be classified as providing financing for: public works and utilities, personal credit, agricultural credit, manufacturing credit, rural settlement and cultivation of the soil, and urban credit and building, *cf.* POOLE. They very much resemble a decentralised RFC and is a much closer equivalent than IRI.

Current German Bank Regulation

During the post-war reconstruction period, there were proposals to recast the German system along American lines (*e.g.* the Dodge Plan of 1945) in order to reduce the potential for the abuse of power by the large banks and industrial cartels which were thought to have brought the National Socialists to power and provided support for German military pretention. Although the large universal banks were reorganised as independent regional institutions (April 1948), the liberalisation of branch organisation introduced in the Large Banks laws of 1952 and 1956, and finally the elimination of any controls on bank location in 1958, allowed the Big 3 banks (Deutsche, Dresdner and Commerz) to regroup their regional units into national institutions within a decade.

The 1934 Bank Law was replaced in 1962, and amended in 1976, 1985 and 1990. The new law preserved the basic regulation of German banks via a Federal Banking Supervisory Office which was made legally independent of the Bundesbank (reporting to the Minister of Economics), although it mandated close cooperation. It also reconfirmed the position of the 1933 Enquiry that direct control over the structure of financial institutions and their entry into particular financial markets was unnecessary, although it did preserve the power to set maximum interest rates (which was quickly abandoned).

The German Bank Law takes an indirect approach to the problem of bank stability and the protection of depositors by requiring a matched maturity structure of the balance sheets of financial institutions via a set of "Principles Concerning the Capital Resources and Liquidity of Credit Institutions".[14] The most basic of these is the 'liquidity principle' (Principle II), which limits long-term lending to long-term funding, defined as the bank's own equity plus sale of bank bonds, long-term borrowing, 60% of savings deposits and 10% of current accounts and time deposits of non-financial entities. In addition (Principle III) the bank's portfolio of loans, advances, discounted bills, quoted shares and liabilities of other credit institutions cannot exceed 60% of current and time deposits of non-financial

[14] DEUTSCHE BUNDESBANK, *Annual Report*, 1962, pp. 97ff. These Principles simply made formal the "Guiding Ratios for Credits" which had been applied previously by the Bank Deutscher Länder and then the Bundesbank.

entities, 35% of the current and time deposits held by financial entities, 20% of savings deposits, 35% of borrowing with a maturity from one month to four years and 80% of the bank's issue of acceptances, notes, bills drawn on itself and international letters of credit.

The capital adequacy rules (Principle I) require bank capital (including reserves and retained earnings) at a minimum of 1/18th (5.555%) of total lending to firms, individuals and its book credits and non-controlling interests. In 1990 this list was extended to include risk adjusted off balance sheet exposures for financial swaps, forward contracts and option rights. In addition, Principle Ia limits a bank's outstanding acceptances, promissory notes and bills drawn on debtors to a maximum of 1.5 times its own capital, calculated and reported on a daily basis. In 1990 Principle Ia "was amended more substantially to limit all 'price risks' – including in particular those arising from off balance sheet financial instruments – to 60% of a bank's liable capital" (1990, p. 39). Within this 60% limit there are individually binding class limits of 30% for foreign currency and precious metal risks, 20% for interest rate risks from interest rate forward contracts and options, and 10% of other forwards and options on shares and index-linked contracts.

Thus, as a result of the spread of new financial products it has been necessary for Principle I to be "extended to constitute a *general counterparty risk principle* going beyond mere credit risk. Principle Ia ... provide[s] a general set of rules aimed at containing ... the *price risks* involved in certain types of transactions which are particularly risk-prone because they require little or no capital input (leverage effect)."[15]

Further, there are regulations on the size of loans: single loans cannot exceed 75% (reduced to 50% in 1985) of the bank's own capital; the five largest loans cannot exceed three times own capital (abolished in 1985) and all large loans cannot exceed eight times loan capital.[16] These large loans, defined as those which exceed 15% of

[15] The detailed procedures for the calculation of the risk adjustments and the computation of the exposure limits is given in DEUTSCHE BUNDESBANK, *Monthly Report*, August, 1990. The weights are generally in line with those in the EEC Solvency Ratio Directive based on the Cooke committee proposals for the BIS international capital adequacy requirements.

[16] In addition, in the 1985 amendment to the Banking Law these regulations were redefined to apply to the consolidated balance sheets of banking groups, *i.e.* to include any company in which the parent bank has 40% capital interest or "direct or indirect controlling influence".

bank capital, have to be reported without delay to the Bundesbank, and all loans above DM 1 million also have to be reported. "The main duty of the recording centre is to ascertain the indebtedness of borrowers who have obtained credits of or exceeding DM 1 million from two or more institutions, and to inform the lending institutions regarding the amount of their borrowers' total credit indebtedness and the number of lenders" (Deutsche Bundesbank, *Annual Report*, 1962, p. 95).

These Principles demonstrate the difference in basic philosophy[17] between the German and US approach to prudential bank regulation and investor protection. The German system does not restrict the field of activity of financial institutions in any way, nor does it attempt to regulate specific financial product markets, rather it imposes prudent banking behaviour on all institutions by requiring a matched maturity structure of balance sheets and imposing minimum capital ratios and maximum risk exposures.[18] Within this structure, financial institutions are free to enter any activity and to act in any market without restriction or other direct government regulation.[19]

It is clear that whatever potential instability which might be caused by a single institution acting as a borrower in the short-term money market and a lender in the long-term capital market is restricted by regulations on maturity matching. Active monitoring of detailed balance sheet restrictions in the German system thus may been seen as a substitute for the market segmentation of the US system.

[17] The approach suggests the German "Ordnungs-" or "Order-" approach to theory and policy based in the work of Walter Eucken which gives priority to the design of the rules and institutions making up the economic framework or "Order".

[18] Since the 1974 Herstatt crisis (which was the result of fraudulent foreign exchange trading) there have been additional regulations limiting open foreign exchange positions to 30% of capital plus reserves and retained earnings and the creation of two institutions to insure depositors' funds: In 1974 the Bundesbank set up the Liquidity-syndicate bank which accepts bills drawn by banks facing liquidity shortages which can be discounted at the Bundesbank, and in 1976 the banks themselves created a private "deposit insurance fund" which reimburses individual depositors for up to 30% of the bank's most recently published net worth statement. Bank membership in both institutions is voluntary.

[19] It is for this reason that legal reserve requirements to insure that "prudential" levels of reserves are maintained by financial institutions are redundant in the German system, although they do provide an important additional tool of monetary control.

The Importance of Post-war Reconstruction

In addition to its unique regulatory approach, the German financial system has been conditioned by a series of decisions made during post-war reconstruction. The 1948 currency reform had the effect of wiping financial balance sheets clean, in both the public and private sectors. As a result, until 1974 the German government was a net creditor to the private sector, while families were slowly rebuilding their wealth positions through small savings deposits.[20] In 1950-51 the savings ratio of private households was barely above 2%. Most firms had been able to write down or eliminate their liabilities and to build "hidden reserves" by overvaluing assets (allowing large depreciation allowances against taxable earnings) when they drew up their new balance sheets in Deutsche Mark. New investment was financed primarily from retained earnings and bank financing rather than through the capital markets.[21]

Finally, the undervaluation of the DM with respect to the US dollar stimulated foreign direct investment, as well as exports. Thus, until the mid-1950s there was virtually no activity in capital markets for lack of issues by either the government or firms on the one hand, and from a lack of demand from households, on the other. Although banks had the ability to act as investment banks, they did very little business in this area.

The reconstruction of the economy was intermediated by the banking system as households' increasing savings were held in savings deposits and as firms expansion outpaced the growth of internal funds, they increased their borrowing from the banks. The following tables show the relative stability of bank deposits in household portfolios along with the slow increase in fixed interest assets and the decline in their holdings of equity.

[20] This helps to explain why open market operations have never played a very important part in monetary policy – the Bundesbank had to be given powers to force the government to create financial assets which it could trade in the markets.

[21] In addition, the tax credits used to encourage investment provided an interesting impact on financial markets. Tax rebates were given on the entire value of interest free loans made by individuals or corporations for the financing of housing, shipbuilding and reconstruction investment by third parties. The loans were taxable when called. See WALLICH, pp. 160ff. Wallich estimates that up to 20% of investment in the housing sector was financed in this way. Accelerated depreciation allowed the firms to keep most of their profits, as assets were overvalued in the preparation of the new DM balance sheets.

PROPORTIONS OF HOUSEHOLDS TOTAL MONETARY ASSETS
(in percentage)

	Bank Deposits	Building Society	Insurance	Bonds	Share	Other
1950	50.00	2.27	16.82	1.36	25.00	4.09
1960	61.56	7.34	17.70	4.94	7.89	7.18
1970	59.07	8.66	16.69	10.24	4.99	6.37
1980	52.99	6.91	17.03	13.21	2.13	9.33
1989	45.59	4.46	21.84	16.77	2.86	8.29

Source: Tables accompanying the article "The capital finance account of the Federal Republic of Germany for (various years)" published annually in the May number of the *Monthly Report* of the DEUTSCHE BUNDESBANK.

This is matched by the slow decline of the ratio of self-financing to gross investment, offset by the rise in borrowing from domestic banks, along with a slow shift in the composition of deposits from domestic to foreign banks.

FIRMS
(in percentage)

	Self Financing Ratio	Share in financial Assets		Share in Liabilities	
		Domestic Deposits	Foreign Deposits	Domestic Borrowing	Foreign Borrowing
1950	71.14	61.88	17.33	48.37	11.16
1960	63.86	50.45	21.68	57.74	7.64
1970	65.79	49.34	25.28	59.74	11.13
1980	67.37	48.71	28.36	60.46	10.18
1989	64.50	40.26	35.85	60.11	9.62
1990	65.00				

Source: Tables accompanying the article "The capital finance account of the Federal Republic of Germany for (various years)" published annually in the May number of the *Monthly Report* of the DEUTSCHE BUNDESBANK.

The decline of internal funding appears to have stabilised in the 1980s, as corporate earnings improved dramatically. This increase in earnings was also accompanied by a three-fold increase in share prices, and an increase in the issue of corporate equity. Thus, the German market was not immune from the global boom in share prices which occurred in the 1980s and listed companies took ad-

vantage of the possibility to increase their equity borrowing. Yet, this did not represent a sharp increase in the role of capital markets in allocating financial resources.[22] At the end of 1990 the number of listed companies was only 42 higher than in 1980, reaching 501, or only one-fifth of the total of public limited companies. There are more than 400,000 private limited companies and 100,000 partnerships in the German economy.[23]

Thus, in the 1980s share financing took on a more important role in providing finance for the small proportion of German firms listed on the stock exchange. At the same time, internal funds also increased and the "own funds ratio" calculated as the ratio of equity capital and reserves to the balance sheet total for public limited companies recovered to 30%, 4 percentage points above the low reached in 1981. New issues were particularly high in 1990 in the boom which preceded the unification. This increase in new issues in the 1980s does not seem to have changed the distribution of share ownership dramatically, although the banks became more active in the process of underwriting the new issues.[24]

PATTERN OF SHARE OWNERSHIP
(percentage of total)

Sector	1960	1970	1980	1990
Households	27	28	19	17
Enterprises	44	41	45	42
Public Authorities	14	11	10	5
Banks	6	7	9	10
Non-Residents	6	8	11	14
Insurance Companies	3	4	6	12

Source: "The significance of shares as financing instruments", *Monthly Report* of the DEUTSCHE BUNDESBANK, Oct. 1991.

[22] This increase, however, is not directly visible in company accounts. The average issue prices for new shares in the 1980s was four times par value. The increase in equity is given in terms of par value, while the excess of issue over par is entered as reserves in company accounts.

[23] In 1987 a secondary market (the "geregelter Markt") was instituted with less stringent listing requirements for smaller firms. At the end of 1990 there were more than 150 enterprises listed. Also in 1987 "Risk Capital Investment Companies", limited liability public companies which raised capital in the stock market to lend to small and medium sized companies unable to meet listing requirements, were introduced. At present there are fewer than twenty such companies.

[24] *Cf.* "The significance of shares as financing instruments", see *Monthly Report* of the DEUTSCHE BUNDESBANK, Oct. 1991.

The German system might thus be described as one in which households hold deposits in banks which are subject to maturity matching and capital controls which ensure their stability and thus indirectly assure the safety of household deposits. The production and investment of private firms is financed by short and medium-term bank lending, the proportions of which are determined by the division of wealth between households and financial corporations. The major issuers and purchasers of bonds are the banking system, while enterprises hold over 40% of the shares issued by the small number of quoted companies.

BANK SECURITY PORTFOLIOS
(in percentage)

	1985	1986	1987	1988	1989	1990	2/1991
Bonds	92.99	91.48	91.86	91.45	89.63	87.69	88.01
Bank	72.00	71.29	70.28	67.50	66.08	64.60	65.43
<4yrs	13.03	12.09	11.89	9.49	7.65	14.71	16.60
Public	20.92	20.11	21.51	23.89	23.49	23.03	22.41
Industrial	0.07	0.07	0.06	0.06	0.07	0.06	0.17
Shares	2.53	2.75	2.69	2.40	3.01	3.43	3.27
Industrial	2.33	2.51	2.30	1.93	2.51	2.93	2.75
Investment Funds	0.73	0.87	1.13	1.33	1.44	1.97	1.98
Other	0.36	0.66	0.43	0.35	0.49	0.52	0.46
Foreign	3.40	4.25	3.93	4.47	5.43	6.38	6.28
Bonds	3.11	3.54	3.41	3.91	4.75	5.92	5.91
Shares	0.20	0.50	0.45	0.48	0.57	0.36	0.28
			(% of total value outstanding)				
Banks holding of:							
Shares	9.03	10.17	10.72	9.87	11.82	14.42	13.55
Bonds	38.89	38.20	38.77	39.85	37.68	36.49	34.89
Bank	42.75	44.20	46.03	47.86	45.01	43.53	41.94
Industrial	11.26	12.07	11.71	12.52	12.95	14.21	35.70
Public	29.86	25.92	25.71	27.16	25.95	25.18	23.39

Source: Monthly Report of the DEUTSCHE BUNDESBANK.

In such a system there is little role for conflicts of interest within banks, for private retail clients hold only small proportions of capital markets assets in their portfolios and industrial clients seldom require the bank to act as underwriter. Capital market assets are primarily held as investments by the banks and are also a favoured source of bank funds, so that any risk which might occur from the process of borrowing short to finance the holdings of long-term capital assets is limited by the constraints on balance sheet ratios. In a similar way, conflicts of interest between the banks and the borrowing firms are limited by the fact that firms issue little equity or bond debt, and by the fact that the banks are also equity holders in the firms so that good firm performance also means good bank performance.

FIRM'S LIABILITIES
(shares of annual flow – in percentage)

	1980	1985	1986	1987	1988	1989
Bank loans:						
short	29.6	9.00	–3.70	–12.30	–17.90	17.76
long	24.5	37.10	59.40	45.50	36.70	43.33
Institutions	4.5	5.90	–0.60	3.60	1.40	0.1
Bonds	0.9	6.20	11.00	14.30	3.50	–0.0
Shares	6.1	7.70	20.00	11.70	5.60	7.22
Money Market Liabilities	1.0	–	–	–0.60	–0.50	–0.21
Other*	33.4	34.10	13.90	37.80	35.60	30.55

* Includes households claims under company pension commitments.

FAMILIES' ASSETS
(shares of annual flows – in percentage)

	1980	1985	1986	1987	1988	1989
Funds placed in Banks	42.1	40.30	53.20	42.20	51.70	22.97
Currency +						
Sight Deposits	3.1	4.00	9.70	9.70	10.30	4.51
Time Deposits	31.6	9.30	9.90	6.80	8.20	31.50
Saving Deposits	7.4	27.00	33.60	25.70	33.20	–12.44
Capital Market	20.7	20.50	8.40	22.40	14.00	32.86
Bonds	20.9	17.70	7.30	18.90	11.00	37.00
Shares	–0.7	2.80	1.10	3.50	3.00	–4.13
Insurance	21.2	31.10	30.80	29.60	30.80	29.60
Pensions	11.3	9.00	9.60	8.10	6.80	7.80

Source: Tables accompanying the article "The capital finance account of the Federal Republic of Germany for (various years)" published annually in the May number of the *Monthly Report* of the DEUTSCHE BUNDESBANK.

The Structure of the German Financial System

In the discussions of the advantages and disadvantages of the German system of universal banking there seems to be a presumption that it is completely dominated by a few, extremely large, universal banks which in addition to being subject to potential conflicts of interest may exercise undue economic and political power because of their size. In the German system this is not the case in any absolute sense; although the universal banks are generally larger than either commercial or investment banks in the US, this is simply because they are not subject to the same constraints on products or geographical location.

Nor is it the case that all banks in the German system operate freely in all markets. As the size distribution of the German financial system indicates, institutions dealing in particular product markets co-exist, and actively compete, with big commercial banks. Just because banks enjoy free entry to all markets does not mean that all banks are active in all markets. Yet, the universal bank form dominates two of the four different types of financial institutions which make up the financial sector: *a)* commercial banks (including the Privatbanken), *b)* public savings and giro banks, *c)* special interest co-operative banks and their giro bank, and *d)* special function financial institutions including public and private mortgage banks, building societies, postal savings banks, consumer credit banks and investment companies.

In general private deposits have been concentrated in the savings banks, although the commercial banks have recently increased their activity in this area.

It is also not the case that there are no geographical limits to the operations of banks. The public savings and giro banks are licensed in each Land, much like State chartered banks in the US, and cannot operate outside their Land. Most of these banks were initially established by local governments to provide financing for public expenditures. Since these banks were operated in the social and economic interest of the areas in which they were located, and since in Europe lower income earners did not generally have access to the commercial banking system until the 1970s, they offered payments services in the form of giro clearing accounts which first linked all the local banks in a single Landesbank Girozentrale, and then through a country-wide clearing via the Deutsche Girozentrale. These banks initially domi-

SIZE DISTRIBUTION OF FINANCIAL INSTITUTIONS BY VOLUME OF BUSINESS: 1990
(m = million DM, b = billion)

	Number	Branches	<100m	100-500m	550m-1b	1b-5b	>5b
Commercial Banks	341	6552	74	100	43	91	33
Big Banks	6	3234	–	–	–	–	6
Regional	192	2976	28	58	28	54	24
Foreign	60	34	13	19	7	18	3
Private	83	308	33	23	8	19	–
Regional Giro Banks	11	311	–	–	–	–	11
Savings Banks	771	19036	7	275	188	267	34
Co-op Giro Banks	4	33	–	–	–	–	4
Credit cooperatives	3392	17402	1903	1288	134	64	3
Mortgage Banks	36	58	–	4	1	4	27
Private	27	50	–	2	1	4	20
Public	9	8	–	2	–	–	7
Postal Giro System	16	–	–	–	–	–	–
Building and Loans	32	63	1	2	7	13	9
Private	19	63	1	1	4	9	4
Public	13	–	–	1	3	4	5
Special Function	18	34	1	2	2	2	11
Total	4621						

Source: Monthly Report of the DEUTSCHE BUNDESBANK.

SHARE OF DEPOSITS BY TYPE OF BANK
(in percentage)

	January 1991			January 1985		
	Total Deposits	Sight Deposits	Time Deposits	Total Deposits	Sight Deposits	Time Deposits
Commercial	39.57	51.16	31.77	33.07	45.94	42.61
Big 3	8.41	7.23	8.76	8.39	13.99	7.01
Regional	24.62	37.80	13.59	13.09	17.41	12.05
Private	1.974	1.56	1.59	2.37	2.84	1.74
Regional Giro	18.38	15.33	35.30	15.17	18.65	21.93
Savings	10.27	7.85	6.67	11.26	4.69	4.58
Regional Co-op Giro	10.77	9.95	13.30	14.46	21.37	20.27
Cooperatives	4.75	3.30	1.50	6.49	2.69	1.96

Source: Monthly Report of the DEUTSCHE BUNDESBANK.

nated deposit-taking in Germany and still have a position equal to that of the commercial-universal banks. Through their Zentrale organisations the individual savings banks located in single Länder combine to form large multi-branch banks which are able to operate just as the larger universal banks and to compete actively with the large commercial universal banks. Each individual savings bank thus has access to the same national and international markets and can offer the same products and services as any large commercial bank, by participating with other small banks through its regional or national Giro organisation.[25]

It would be inappropriate to push the analogy too far, but the German public savings banks face restriction much like State chartered unit banks in the US system, restricted in terms of branching to a particular region and are much like savings and loans in the restrictions on the types of investments which they may undertake. The difficulties that these restrictions have caused in the US have been alleviated by the operation of the centralised clearing organisations which have allowed the smaller banks to operate as partners in a larger single bank which is not bound by the same regulations.

Banks and Corporate Control

While the universal bank system does preserve substantial competition and has strong supervisory controls on balance sheets which prevent excessive risk in a single bank which takes both short-term deposits and is free to invest in corporate equity, there is one difference that is of importance. In the German universal-bank dominated financial system, corporate equity appears to be predominantly controlled, if not directly owned, by the universal banks, rather than private individuals (or the representatives of private individuals as in the case of the large US institutional investors such as pension funds, insurance companies, investment and mutual funds). Despite the fact, noted above, that officially reported bank holdings (which understate

[25] This is similar to the correspondent system which existed in the US before the Pepper-McFadden Act of 1927 and the 1933 Glass-Steagall Act. In the absence of this legislation a natural evolution of this system would have been for the larger money center banks to take participations in their regional correspondents to form large national clearing structures which channeled funds to the larger main banks of a form very similar to that in Germany.

actual positions) are a relatively small proportion of outstanding corporate equity, this is not a good measure of the influence exercised by universal banks.

First, the Commission of Enquiry on "Basic Banking Questions" set up in 1974 to recommend changes in the commercial banking system reported that in 1974/75 while banks owned only 9% of corporate capital stock, they represented 62% of the votes at stockholders meetings (the "Depotstimmrecht" gives the bank the right to represent beneficial owners of shares which they hold as custodians or in trust accounts) and held 18% of the seats on corporate supervisory boards. In addition, the preponderance of short-term lending in firms' total financing means that banks will be more directly involved on a day to day basis in major financing decisions. Although much has been made of the role of the "Hausbank", most German firms have now outgrown the ability of even the largest bank to provide all their required services, yet the high proportion of short-term lending which must be continuously re-evaluated and rolled over means that contacts between firms and their bankers must be active and continuous. In this way short-term lending takes on a long-term character, and it follows as a by-product of this system that only a small proportion of firms seek public listing to raise equity capital. Until 1990 there were fewer than 500 publicly quoted companies (AG). Indeed, it has been the banks, rather than firms, which have been the most active participants in both the debt and equity markets in recent years.

Conclusions

This review of the German financial system suggests that the most significant aspect is not the lack of regulation permitting universal banking, but rather its diverse approach to regulation which substitutes balance sheet regulations for the controls on liabilities and assets produced in the US by market segmentation and which has thus allowed both universal and specialised banks to co-exist. In this sense the US system was just an indirect method of controlling the maturity structure of bank balance sheets which in Germany is directly applied to all banks.

For the USA

This suggests that those who have considered the introduction of "universal" banking as a possible remedy to the US banking crisis and as a way of providing a "level playing field" for commercial banks with respect to investment bank-broker-underwriters, have not recognised the degree to which this increased freedom could only be countenanced if changes were made to introduce German style banking supervision and balance sheet regulation[26] and would include the following radical steps given the current discussions on banking reform in the US:

1. The introduction of a unified supervisory structure for all financial institutions.

2. Single, national charters for all financial institutions.

3. Detailed balance sheet regulations to match maturities and risks.

4. Free entry of all financial institutions into all areas of business, geographically and by product.

5. No limitation on mergers of financial institutions, either within or across product or geographical area.

6. The elimination of government sponsored deposit insurance.

7. The provision of a public transactions structure for individuals. The Fed already provides a clearing house for large transactions of financial institutions, the Post Office could provide a similar clearing house for small payments for individuals who do not have access to the financial system or who do not wish to bear the risk associated with private transactions structures offered by financial institutions.

8. A full revision of SEC legislation.[27]

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[26] It is interesting to note that in precisely the period in which capital adequacy requirements were being introduced on an international basis, a comparative study of the financial structure of the G-10 countries (Cumming and Sweet) did not even consider balance sheet restrictions imposed by the national supervisory authority.

[27] Since the SEC is the result of the segmentation between deposit banking and investment introduced by the 1930s legislation many of its activities would be redundant in a universal system under a single supervisory authority, in particular most of the consumer protection provisions concerning information disclosure by firms and securities institutions. Its basic activity would remain oversight of organised financial markets.

Anything short of these provisions would run the risk of recreating possibilities for abuse as great as those which existed in the 1920s and again in the 1980s. It should be clear that the introduction of universal banking is more than just removing barriers between financial product markets to create a level playing field, it requires the construction of an alternative set of uniform barriers in the form of a uniform regulatory structure. It is not clear that either the Congress, or the commercial banks or investment banks recognise the extent of the new regulations which would be required to replicate the supposed advantages of the German system.

Neither is it clear that the potential conflicts of interest, which are absent in the German system due to the peculiar structure of asset holdings which developed in the post-war period, would be absent in the US where equity financing and equity investment form a much larger proportion of firms' funding and households' investments and where proprietary trading forms a large proportion of the earnings of an increasing number of large banks.

For the EEC

As far as the European Community is concerned, most commentators appear to have based their analysis of the dominance of universal banking on the freedom of action allowed to German universal banks, without considering the regulatory restrictions on their balance sheets, or recognising that although this freedom is general to all financial institutions, there is still a great deal of specialisation and substantial size diversity in the German system. Further, since these restrictions are part of the German financial system's "prudential regulation", it is unlikely that Germany would allow foreign based "universal" banks to operate within Germany without similarly strict balance sheet regulations. Nor is it obvious that such detailed regulation would be highly attractive to foreign banks seeking to locate in Germany to benefit from "universal" banking. Indeed, this suggests that the question of competition between different institutional forms within the EEC will be closely linked to the question of the prudential supervision of banks within the EEC. Just as in the US, it seems clear that the major prerequisite for the successful functioning of the universal bank system would be the creation of a single EEC agency with responsibility for bank

supervision, independent from the European Central Bank, but which cooperates closely with it. It is interesting to note that the amendments to the Rome Treaty proposed in Maastricht make provision for European Central Bank cooperation with such an independent agency at the Community level, but that as yet no formal provision has been made for its creation. It is unlikely that Germany will relinquish these prudential controls over its own banks, nor will it allow domestic competition from non-German "universal" banks not subject to the same controls, without similar legislation at the Community level. It would appear that a major chapter of banking supervisory law has still to be written by the Community before either full monetary union or the predominance of universal banking in the EEC can be considered a real possibility.

On the other hand, given its regulatory structure, Germany will be better placed to reduce or eliminate the costs imposed by other types of prudential regulation, such as reserve requirements or deposit insurance, which play a relative minor, and technically redundant, role in German prudential regulations and serve only as controls on money creation.

Finally, it is of note that universal banking has not become dominant in Germany, so that there is nothing to suggest that it should become dominant in the Community as a whole, even if this is made possible by the adoption of the Germany supervisory system as the community standard.

Conflicts of Interest

While balance sheet requirements can do much to curb the risk of maturity and interest rate mismatches which might occur under universal banking, they can do little to eliminate conflicts of interest. The absence of conflicts of interest within the German system seems to have been the happy result of spontaneous market segmentation resulting from the post-war development of the German economy. If private clients seldom hold capital market assets directly and when banks are themselves the largest issuers and holders of securities, the possibility for the kinds of conflict of interest, or fraud and abuse, such as characterised the 1920s, is greatly reduced, although this has not prevented particular cases within the larger German banks. Since this particular structure of asset holding grew out of the experience of

post-war reconstruction under Germany's specific banking law, it cannot be replicated in other countries, nor can it be guaranteed to persist in Germany. The problem of conflicts of interest remains to be tested by universal banks who are active on both the issuing and placing sides of the equity markets.

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