# Commentary: Financial Markets in Transition—or The Decline of Commercial Banking

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There is no doubt that the financial sectors of most of the industrialized countries have been undergoing enormous structural changes for at least the past decade, and are likely to continue to do so for the foreseeable future. Professor Edwards' paper should prove a valuable reference on this subject; it provides a useful combination of factual material putting these developments in historical perspective, analysis of their driving forces, and discussion of their policy implications, particularly in the area of financial regulatory policies. My comments that follow are concerned mainly with questions of emphasis and with amplifying in a few areas where this can usefully be done.

## Factual background

Let me first take up the factual part of the paper. It puts together an impressive collection of data to illustrate the nature of the structural changes that have been taking place. The main stylized facts to emerge could be summarized as follows:

(1) Commercial banks in the United States have suffered a long-term decline in their share of the financial sector—roughly a halving of market share, measured by total assets, since the beginning of this century. The corresponding gainers have been pension and insurance funds and other kinds of collective investment institutions.

(2) This trend has tended to accelerate in periods of rapid financial expansion and innovation, notably in the 1920s and 1980s.

**(3)** The changing institutional structure of financial intermediation in the United States has been accompanied by substantial changes in the instruments and technology of financial intermediation, including particularly the trend toward securitization of financial claims and the increasing availability of derivative instruments.

(4) During the past decade, similar trends to these have been evident in several other countries including the United Kingdom, Japan, Australia, and the Scandinavian countries—broadly the group of countries that experienced the most pronounced financial expansions during the 1980s.

I would not seriously dispute any of these conclusions emerging from factual analysis, and indeed they are in broad agreement with observations made in a number of recent studies by the Organization for Economic Cooperation and Development (OECD).[1] However, the data shown in the paper probably exaggerate the extent of the decline of the banking sector. Regulations that discriminate between types of activities by institutions create incentives for them to change legal forms even when there may be little or no change in the substance of what they are doing; examples include the setting-up of nonbank subsidiary companies by banks or the creation of new financial instruments to bypass regulatory constraints, trends which would tend to reduce banks' apparent market share when measured using balance-sheet data. This said, however, it is clear that the financial trends outlined in the paper are of considerable importance.

## Two key features of financial market trends

My somewhat more detailed comments shall focus on two key features of financial market trends, especially from the point of view of comparison across OECD countries, since the paper basically discusses the U.S. situation. They are the trends toward securitization and financial conglomeration.

## *Securitization*

Some observers argue that securitization, which is one of the striking features of financial development in the 1980s, will inevitably erode the scope of the franchise traditionally enjoyed by banks. Increased recourse to the traditional forms of securitization such as the issuance of bonds and commercial paper has been observed in most OECD countries, but there has been growing divergence between the United States and other OECD countries with respect to the more sophisticated "generation" of securitized activities. The development of asset-backed and mortgage-backed securities has made major inroads only in the United States. Most of the mechanisms currently being used in securitization were developed in the United States, and thus reflected U.S. laws and practices. Incompatibilities of legal systems can arise when attempts are made to transfer American techniques to other countries. However, even in such countries as the United Kingdom and Canada where the legal system is relatively similar to that of the United States and the transfer of "securitization technology" should be relatively easy, markets in asset-backed and mortgage-backed securities do exist, but have not attained the proportions reached in the United States. There must also be other factors at work.

There are some special features of the U.S. banking system that have encouraged the expansion of securitization, such as the large number of small banks and the lack of geographic dispersion. The tradition of competition between banks and capital markets and the recourse to fixed-rate mortgages have also been significant factors. On the other hand, the prevalence of the universal banking system and the consequent capability of indigenous banks to prevent competitors from encroaching on traditionally profitable areas of activity are often cited as among the factors that have inhibited the advance of securitization in continental Europe. Some aspects of attitudes in the European financial community can also be noted. Securitization has come to be perceived as a "distress technique" that is used by institutions which have difficulties or which have low-quality assets they wish to sell. Moreover, in many countries, the spreads among borrowers with different risk ratings are not as wide as in the United States, thus lessening incentives to engage in securitization. For many European countries, the capacity of banks to hold onto their traditional business has been backed up by the authorities who, observing the experience of countries with radical disintermediation and concluding that the results have on balance been unfavorable, have limited the scope for disintermediation.

In Japan, the downgrading of banks and the overhang of impaired assets as well as internationally agreed capital adequacy rules tend to create more favorable conditions for securitization. Even so, it is unlikely that securitization will undergo major expansion in corning years, given the cautious stance of the authorities and the attitude of nonbank investors which may remain highly risk-averse, following the financial excess of the late 1980s.

Regardless of how far it may advance in particular countries in coming years, securitization represents a permanent change in the financial systems of virtually all OECD countries, and banks would have to adapt their activities accordingly. Notably in the United States, where the banks had long ago lost their large and highly rated corporate borrowers to the capital markets, securitization has offered an opportunity to recapture some of their business opportunities by acting as originators or servicers of securitized assets. Indeed, securitization can be seen as the process through which banks seek to earn fee-based income rather than holding assets on the books at a time when banks are under internal pressure as well as constraints from supervisory authorities to maintain relatively high capital/asset ratios. In the financial markets of the future, banks are likely to earmark greater resources in this direction as opposed to traditional lending.

### *Conglomeration*

The second key development is the trend toward financial conglomeration which has generally accentuated in OECD countries during the past fifteen years or so. This has been particularly the case for ownership and operational linkages between banks and securities firms on the one hand, and banks and insurance companies on the other. The creation of fully fledged conglomerates (linking institutions operating in *all* segments of the financial services industry) has been rare. But the subject has become increasingly topical in Europe in the context of the Second Banking Directive of the European Community (EC) under which EC credit institutions are allowed to carry out investment business, as well as traditional banking business, anywhere in the EC.

However, it is far from proven that economies of scale and scope are so large as to justify a rush into conglomeration. The OECD-sponsored survey of the literature on this issue[2] confirms that, on the basis of the findings of more than 100 studies carried out between 1982-1991, existing empirical studies do not yield conclusive results as to the existence of significant economies of scale and scope in the financial services industry and that, at the level of cost efficiency, the effects of organizational inefficiency (failure to attain cost control and efficiency at the management level) are much more important. These observations are particularly relevant in the context of mergers and acquisitions, and the related issue of the extent to which they could contribute to remedy the problem of overcapacity in the financial services industries. The problem of overcapacity cannot be solved by mergers, unless they are accompanied by a substantial release of resources previously employed in the financial institutions. Once financial institutions reach a relatively moderate size, it is not certain that they can become more efficient with growth. Experience would seem to suggest that often very large financial organizations become progressively less profitable, as growth is sought as an end in itself.

When OECD governments intensified the policy of liberalization and deregulation of financial markets in the 1980s, many observed that the future would hold a growing despecialization and internationalization. Recent developments suggest that the actual picture will be more nuanced. Regulatory changes and technological development in the future may further weaken the segmentation of financial markets in many OECD countries, and increase the possibility for financial institutions to enter new grounds at their discretion. However, rather than an exclusive despecialization and conglomeration, individual financial institutions may become more inclined to select only those activities which they themselves judge as best-suited for their specific circumstances.

This scenario leads into the final set of issues raised in Professor

Edwards' paper, namely, does the relative decline of traditional banking matter, and how should regulatory policies respond? I shall leave issues concerning the implications for the conduct of monetary policy to speakers in the subsequent sessions.

## Implications for regulatory policies

As Professor Edwards' paper suggests, answers to the question raised above depend importantly on one's view of the underlying rationale for financial regulations. To put this issue somewhat differently from the way it is set out in the paper, two broad approaches can be distinguished. The first, what I would call the functional appro'ach, holds that banks and other financial institutions are regulated primarily because of the adverse externalities they may generate. For example, it might be argued that financial intermediation without 100 percent reserve backing inherently carries the risk of "runs" occurring in individual institutions which could also threaten the stability of the financial system as a whole. In this view, it makes sense to design regulations on a functional basis, across institutional boundaries: that is, to regulate the particular activities that are thought to generate these systemic risks, whatever institutions are engaged in them. This is the thrust of the argument of those who favor, for example, a "level playing field" between banks and securities firms.[3]

The second view, which I would call the institutional approach, is that institutions are regulated to ensure a spectrum of choice for the purchaser of financial services. This would argue that, since many of those purchasers (especially consumers and small businesses) cannot easily monitor the safety of financial institutions, it makes sense for regulators to set up a regulated "safe" class of institutions (for example, banks), whose optimal size can then be determined by market forces. Agents would also be free to conduct their business outside the regulated sector where that was more efficient. In this view, a decline in the relative size of the regulated sector would not be a cause for concern, provided it was not brought about by some defect in the regulations themselves.

Our current system of regulations clearly has elements of both these approaches underlying it. However, current trends appear to be for a shift in the direction of a more functional approach to regulation, toward greater consistency of regulations across institutional types. This is at least partly a response to the expanding market share being gained by the nonbanks. Whether or not this is a sensible response, and how far it should go, may be something that can usefully be discussed in this conference.

## Endnotes

[1]See, for example, the OECD's recent submission to the G-10 study, ***International Capital Movements and Foreign Exchange Markers,*** April 1993 (Annex III); see also OECD, ***Banks Under Stress,*** 1992.

[2]See Giancarlo Frestieri, "Economies of Scale and Scope in the Financial Services Industry: A Review of Recent Literature," in ***Financial Conglomerates,*** OECD, 1993.

[3]For a critique of this approach, see Schaefer, "The Regulation of Banks and Securities Firms," ***London Business School,*** (August 1989).