The Entry of Commercial Banks into the Securities Business:

A Selective Survey of Theories and Evidence.¹

Raghuram G. Rajan

Graduate School of Business
University of Chicago
1101 East 58th Street
Chicago, IL 60637

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In recent years, there has been considerable interest in whether commercial bank powers in the U.S. should be extended, i.e., whether specialized commercial banks\textsuperscript{2} should be allowed to become universal banks and provide additional financial services such as underwriting, brokerage, and insurance. The economic debate revolves around three questions: first, will banks be more, or less, efficient than existing producers when they provide the proposed service? Second, will the extension of banking powers affect the stability of the financial system? Third, should the government be in the business of setting limits on bank activities? Unfortunately, many of the participants in the debate start with an answer to the third question, which then frames the way they view the first two.

What is also often not recognized is that the debate in the U.S. takes place in a country which has perhaps the most sophisticated financial system in the world. In this system, commercial banks coexist with liquid financial markets, extensive information gathering and certifying agencies, a tried and tested regulatory apparatus, strong reputable firms, and a democratic political system with substantial checks and balances. The above questions are static in the sense that they take as given the existence of competitive institutions and markets and then ask if there are any gains to universal banking. Provided externalities can be limited, the answer is almost surely in the affirmative. In other words, if the implicit or explicit deposit insurance subsidy can be regulated so as to not spill over to the underwriting activities of the banks, given that U.S. markets for various financial

\textsuperscript{2} Typically, commercial banks are intermediaries who take in demand deposits and make commercial loans. Sometimes it seems there are as many definitions of universal banking as there are additional activities commercial banks can get into. For some (see Berlin, John and Saunders (1993), for example), the defining feature of universal banking is the ability of banks to hold equity in firms -- the so-called link between banking and commerce. This has always been frowned upon in the U.S. (see Féin (1986) and Roe (1994)) though early banks may have held substantial investments in firms (see Lamoureaux (1994)). For others, the defining characteristic of universal banking is the ability of commercial banks to underwrite corporate securities and offer brokerage services. It is this that has been the focus of legislative debate in the U.S., and will be the definition we employ in this paper.
services are by and large competitive, universal banks will internalize most of the economic costs inherent in the activities they choose. There is no harm then in letting commercial banks and investment banks choose the range of activities -- universal or specialized banking -- that they think most efficient.

The point of this paper is that in developing countries and in the formerly Communist economies, the *dynamics* of the growth of markets and institutions become more importance. There are both economic and political reasons why the kinds of powers banks have in a nascent economy will affect the kinds of institutions and markets that emerge. From an economic standpoint, this paper will argue that while we can list the benefits and the costs of universal banking, we have little idea about their relative magnitude. In the absence of competing specialized financial intermediaries, we cannot even be certain that banks will choose the range of activities that enhance societal welfare the most. From a political standpoint, we know even less. Banks work because they aggregate savings and invest them in ways that reduce agency costs and asymmetric information. Their function ensures that they attract, and can direct the use of, considerable financial resources. This gives them economic power, and in nascent economies where industrial firms are small and disorganized, there is little in the way of countervailing economic power. Banks can consequently acquire substantial political power, a fear that has influenced banking regulation through American history (see Roe (1994)). Whether they use their political power to enhance efficiency or suppress competing institutions and markets is an open question.\(^3\) It is worth debating whether a more fragmented financial system created by restricting banking powers will result in a more democratic political system -- which, in turn, ensures the financial system stays competitive. Whatever the

\(^3\) Typically, governments think banks too important to be owned privately. Regardless of who owns the banks, the incentives, and the ability, to suppress competition do exist.
answers may be, it is clear that history matters, and the extent of banking powers in a nascent economy will affect economic growth and political development.

It is, of course, impossible to do justice to all these issues in a book, let alone a paper. So this paper will address an even smaller piece of the puzzle; the economics of commercial bank entry into the securities business, especially underwriting. I will focus largely on how universal banking can potentially affects the cost of funding firms and the possibility of bank failure -- both in a developed economy and in an underdeveloped one. It is also clear that universal banking will also expand the range of services banks can offer individual investors. Though this issue is important, there is less economic controversy here, and the paper will largely ignore this side of universal banking.

Some arguments for allowing (prohibiting) banks into (from) the securities business are important because they have intrinsic merit. Others have gained popularity (and hence importance) because they seem to have undeniable merit when viewed from the perspective of undergraduate economics i.e., in a world where most technologies and markets are competitive and information is publicly and freely available. While this may indeed approximate reality in the U.S., it is not at all obvious that it does in other countries. So the paper starts by explaining why some of the 'obvious' arguments are incomplete or patently wrong. It then focusses on good arguments for and against bank entry into the securities business, and gauges the importance of these arguments for economies in different stages of development. The analysis raises many more questions than I have answers for. So this paper is also a call for more research, especially empirical.

I. The Patent Fallacies.

A. The naive investor.
An important historical rationale for the Glass Steagall act was that banks suffered from conflicts of interest when they combined lending with underwriting. Specifically, it was alleged that after making loans to firms which turned sour, commercial banks fooled the naive public investor into buying securities issued by these firms, and used the proceeds of these issues to get their loans repaid. But economic theory suggests that if investors are moderately rational, they will take the bank's incentives into account when pricing the issue, and impose a 'Lemon's' market discount. Thus they should not be fooled on average.

All the evidence we have suggests that investors are indeed approximately rational and do take account of a seller's incentives. But we have specific evidence on the underwriting activities of commercial banks prior to Glass Steagall. Kroszner and Rajan (1994 a) compare the relative performance of securities offered by commercial banks with those offered by independent investment banks prior to the Act. They find no evidence that commercial bank securities affiliates systematically dumped low quality securities on the public, nor that these securities were systematically overpriced. In fact, they find that commercial banks underwrote higher quality securities. This finding has subsequently been confirmed by Ang and Richardson (1994) and Puri (1994 a). While it is possible to find isolated evidence of investors being ripped off -- the recent MMM Ponzi scheme in Russia is an example -- the evidence suggests that it is incorrect to generalize from this and assume that most investors are naive. The focus of legislative action should

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4 We focus on this one because it is often used to justify continuation of Glass Steagall restrictions. Consider the following in The Economist (Nov 28, 1992): 'At the very least, the big stockbroking firms [in Japan] argue, banks should be forbidden to underwrite equity issues for companies to which they act as the "main bank". Brokers cite the abuses which led to Glass Steagall in America and its later Japanese version, especially the possibility that banks will sell the securities of an over-indebted customer to an unsuspecting public.' As Benston (1990) illustrates, there were other variants of these allegations. For instance, banks were accused of stuffing the securities they could not sell into the trust accounts that they managed. Ultimately, many of these allegations boil down to the fact that there are some investors who are naive and who do not price out conflicts of interest ex ante.
be on ensuring that a security's risks and the seller's (or underwriter's) interest in it are adequately disclosed. To the extent that it goes further and prohibits commercial banks from selling corporate securities to the "naive" small investor, it has been misplaced.

B. More entry implies more competition which is always better.

The securities business is often viewed as generating excess profits. The large salaries in the business often make headlines, and the industry has repeatedly been investigated because of allegations of uncompetitive practices. Hayes and Spence (1983) and Pugel and White (1985) find some evidence that securities firms have market power in the United States. Presumably, in less developed economies, securities firms may have even greater market power. But it does not immediately follow that the entry of commercial banks into the business will make financing more competitive.

The important question that is often left unasked is why these alleged excess profits exist in investment banking. One answer could be that there are few large investment banks who, protected from competition from commercial banks, collude (this seems unrealistic in the U.S. where there are many large investment banks). But the prohibition on the entry of commercial banks into the securities business does not restrict entry to other non-bank financial firms. So if indeed there are excess profits, there must be something in the nature of the securities business that keeps others out. The natural candidates are set up costs and increasing returns to scale. Because investment banks need a minimum level of reputational and pecuniary capital to perform their certification and insurance function, and because there are fixed costs in building a network of investors or

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5 For example, the Pujo Money Trust investigation.
establishing relationships with issuers, there may well be substantial barriers to entry.\(^6\)

But how will the entry of commercial banks into the business change this. It could be argued that because large commercial banks have their own reputation and capital, and they have their own networks and relationships, they will prove effective competitors. But then one should recognize the possibility that they will be too effective, foreclosing market share and driving out the specialized investment banks. The identity of the oligopolist will simply have changed. But the greater worry now is that the banks have much greater power over firms, controlling access to both public markets and loan markets (also see Rajan (1994 a)). There are obviously negative aspects to this heightened market power which I will return to later.

In addition to the prospect of greater competition in underwriting (which I have just argued may be a mirage), an argument for allowing banks into the securities business is laissez-faire. Why not let competition winnow out the weak, letting the strong and efficient survive? The beauty of this argument is that one need not be concerned about the efficiency of universal banking relative to specialized banking, because the more efficient structure will prevail. As Rajan (1994 a) points out, this relies on at least one of the intermediated markets (lending or underwriting) being competitive. Otherwise one cannot be confident that competition results in the survival of the most cost effective intermediaries. If universal banking is inefficient but also a source of sizeable ex ante rents, banks may forego the more efficient specialized structures in order to capture the rents.

The point in all this is that it is unlikely that the securities business is the textbook competitive industry. If indeed there are excess profits (and I am not arguing there are), economists

\(^6\) See, for example, Beatty and Ritter (1986) and Chemmanur and Fulghieri (1993) on the importance of reputation in the certification function performed by underwriters, Benveniste and Spindt (1989) and Calomiris (1993) on why networks of investors matter, and James (1992) on set up costs in firm-financial intermediary relationships.
must understand the source of these profits. It may well be that these profits will not be driven away by the entry of commercial banks, and may be increased. Without understanding the nature of the securities business in a particular economy, vacuous statements such as "allowing more entry implies more competition" are unhelpful at best, and dangerous at worst. Furthermore, rather than survival of the fittest intermediaries, the introduction of universal banking could lead to the survival of the fattest.

C. They do it, so....

Until recently, a strong impetus for moving the U.S. towards universal banking was the performance of economies with strong bank-based financial systems. The tremendous rate of growth in Japan and Germany led a number of analysts to ask if the bank based financial systems of these countries were responsible. Some analysts have imbued Japanese and German banks with immense foresight, supreme forbearance, and a significant sense of social responsibility. While some of this enthusiasm can be dismissed as faddish (an equally large number of analysts are now bemoaning the coziness and lack of transparency in the Japanese banking system that has lead to large loan losses), it is legitimate to ask in what ways the financial systems of these countries aided growth.

Clearly, the wrong way to go about this is to regress economic growth against the extent of bank powers or the size of the banking sector for a bunch of countries. Correlation does not indicate causality. A potentially more useful way is to attempt to identify exactly how the nature of the financial system affects economic growth. An example of work along these lines is Calomiris

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7 One of the better reasoned articles in this genre is "Learning from Germany and Japan" by David Hale in the Wall Street Journal, February 4, 1991. Typically, banks in these countries are thought to take the long term view and to never interfere in firms unless absolutely necessary. They rescue failed firms thus insuring other creditors. They always vote shareholder proxies in the interests of the shareholders and not in their own interest. They never exploit their inside position to extract rents. Only recently has the financial press recognized a downside to these kinds of systems -- see "Big Franfurt Banks Concentrate Power" in the Wall Street Journal, May 12, 1994.
(1993). He argues that German firms in the late 19th century had cheaper access to equity markets because the wider distribution networks of German banks enabled them to charge lower underwriting fees. This, he suggests, accounts for the superior rate of investment and growth in Germany (as compared to the U.S.). There are, however, two problems in drawing policy conclusions from this kind of analysis.

First, there is the standard economic problem of the omitted variable. Even if German banks charged lower underwriting fees, were they charging higher fees elsewhere? Has some variable been omitted in comparing Germany and the U.S.? What is worrisome is the sharp drop-off in equity issuances in Germany especially post World War II (see Loughran and Ritter (1993)). If universal banking reduces the cost of equity issuances, as Calomiris suggests, why was there a long hiatus in such issues in the German economy?

There is a more important problem. A growing literature suggests that institutional features cannot be transplanted in isolation and be expected to have the same effect that they have in a different setting. Grief (1993, 1994) describes the importance of cultural beliefs in influencing the nature of optimal contracts and institutional arrangements. Petersen and Rajan (1994 b) show that a relationship based financial system and a transactions based system are, in general, incompatible, and it may be wishful thinking to expect to combine the best of both. If I argue on similar lines, then even if Calomiris is right about the channels through which universal banking works, transplanting a specific feature from Germany to the U.S. carries no assurance that it will work. As an example, unlike German banks, U.S. banks did not seem to have a competitive advantage in underwriting equity issues when they had securities powers in the 1920s (see Kroszner and Rajan (1994a)). The explanation may be that some of the benefits of universal banking accrue only when a whole system
is imported rather than when only selective features are adopted.⁸

At the risk of stating the obvious, the serious economist has to establish the micro-foundations of why a particular feature of a financial system (such as the ability of banks to underwrite equities) affects economic growth. She then has to establish that her arguments have empirical merit both over time, and across countries. If her theories work only selectively, she must explain what else is needed to make them work all the time. This is indeed a demanding agenda, but without this level of rigor, the research in this area is unlikely to change anyone's priors substantially, or influence policy.

II. Why banks should be allowed into the securities business.

The preceding section does not imply that there are no reasonable theoretical arguments for why banks should - or should not - enter the securities business. There are, and I will enumerate them. But as the reader will see, we do not know the magnitudes of the effects or how they interact. This should limit the confidence with which economists can tender advice on the subject. I start with arguments about increased efficiency and stability for why banks should be allowed into the securities business.

A. Economies of scope.

A universal bank may bring scope economies to servicing firms who need funds. For example, credit evaluation is an important step in any funding process. It should be relatively cheap for a bank that has a lending relationship with a firm to perform a due-diligence analysis of the firm for the purposes of underwriting a new issue. Information re-usability (see Greenbaum, Kanatas and

⁸ Along these lines, Rajan (1992 b) argues that if banks are allowed to underwrite corporate securities, it may also make sense to allow them to buy equity in the firms they underwrite so as to signal the value of the issue and offset any conflict of interest. Berlin, John, and Saunders (1992) argue for allowing banks to hold equity to signal firm value and reduce agency problems in firms.
Venezia (1989) for example) is thus a source of scope economies. Whether these are significant is an empirical question, which I will discuss shortly.\(^9\)

There may also be scope economies in reputational and pecuniary capital. So long as there are spillovers in reputation\(^10\), a universal bank can use the reputation acquired in one business to insure another. To the extent that it is easier to gain a reputation in some businesses than in others\(^11\), and to the extent that there are fixed costs in gathering reputation\(^12\), there may be advantages to universal banking over specialized banking.\(^13\)

Finally, a universal bank which combines the asset intensive lending business and the fee generating securities business may be able to fund itself more easily than specialized banks who

\(^9\) Scope economies may also exist in serving investors. A depositor may want to conduct mutual fund transactions, brokerage transactions, and real estate transactions through the same institution. There is, however, little evidence that customers really want one-stop shopping. Attempts by firms like Sears to set up financial supermarkets have not been successful. The reason may simply be that unlike firms, individual investors face small transactions costs in picking the best specialist for an investment.

\(^10\) By spillovers in reputation, we mean that malfeasance in one activity hurts a bank's reputation and its ability to transact in another activity. This would happen if the revelation that brokers working for a universal bank unnecessarily churned small accounts reveals something about managerial oversight in the universal bank which, in turn, reveals something about whether the bank will be a good counterparty in a swap transaction. If the units of the universal bank were managerially isolated, and have different names, it is less clear that there would be reputational spillovers.

\(^11\) For instance, in some activities there are few opportunities for a bank to reneg on commitments, even though reneging may be very costly for a counterparty. Thus a newly entering bank may find it very hard to build a reputation if it were confined solely to that activity. Furthermore, there may be a substantial discount on the price it can charge because of the possibility of reneging. The young bank would bear the discount for a long time. This may reduce its incentives to enter. By contrast, if it could also enter activities where the opportunities to reneg on commitments are frequent, it could build a reputation much more easily and reduce the discount fast. This would facilitate entry and increase competition.

\(^12\) Once the bank has gained a reputation, it can extend its brand "umbrella" to other activities which require reputational backing, at no additional cost. This is, for example, one reason why investment banks can earn rents from certification.

\(^13\) There may also be diseconomies of scope stemming from reputational or pecuniary capital. To the extent that a new activity is not well supervised, there may be adverse reputational or pecuniary spillovers to the rest of the bank's business. The weakest link in a bank's business can impose significant costs on the bank. Of course, this is not a reason for restricting the kind of businesses banks can enter, but it is a reason for banks to be cautious.
focus on one or the other. As Myers and Rajan (1994) argue, bank debt capacities (or equivalently, their cost of funding) may have decreased with the substantial increase in liquidity (and hence scope for possible moral hazard) of their traditional assets, loans. But this may also give them a comparative advantage in funding fee generating activities such as the securities business. The fees (and the associated franchise value) ensure the bank is not tempted to shift risk by altering its liquid loan assets, while the liquid loan assets serve as collateral for the borrowing needed for the fee business.\textsuperscript{14}

The above discussion suggests that there may be scope economies in combining activities. Unfortunately, we have little evidence for this. A vast literature on cost functions in banking (see Berger and Humphrey (1991), Pulley and Humphrey (1993) and the references therein, for example) finds little evidence of scope economies. The problem with these tests, however, is that they may not have much power.\textsuperscript{15} Researchers are using more refined econometric methods of estimating cost functions, but I suspect that far greater advances can be made by collecting more micro-level direct data on the interaction between activities.

\textbf{B. Banking relationships and the cost of capital.}

Bankers in the U.S. usually claim that small business loans are not worth the trouble: Given the small size of the loans to these firms, the fixed costs of investigating the firm and servicing the loan are too high. But the average growth rate of small firms is high. One might think that a bank

\textsuperscript{14} This is similar to Keeley's "franchise value" hypothesis but differs in its emphasis on liquidity.

\textsuperscript{15} As pointed out by Pulley and Humphrey (1993), the cost economies estimated by the translog cost function and its Box-Cox variants which have been traditional in this literature vary a lot depending on how close the point of scope economy is to complete specialization. This literature has also had considerable trouble separating inputs from outputs. Finally, the noise in a bank's reported costs (and revenues) may be considerable.
would take the long term view and invest in these firms hoping for a greater share of their business if they are successful. They do not do this for good reason. In practice, once a firm turns out to be a good credit risk, it can raise money from the public markets and leave the banks. Thus banks cannot recoup any subsidies on initial loans given to start-ups (or equivalently, to distressed firms), which prevents them from lending in the first place.\(^\text{16}\) To the extent that banks can enter the underwriting business and continue to get the firm's business, they may be more willing to finance the firm upfront. Thus one way universal banking can enhance the availability of funds to small or distressed firms in an economy is by increasing the time period over which banks and firms do substantial business together and share a mutually beneficial relationship.\(^\text{17}\)

Universal banking also increases the points of contact a bank has with the firm. As earlier argued, this may be a source of scope economies because the bank can amortize the fixed costs of setting up the relationship over a number of products. Furthermore, cross-selling may be a source of additional information about the firm's activities. It may also provide the bank greater leverage over managerial actions, thus reducing agency costs. Consistent with all this, Petersen and Rajan (1994 a) find that the larger the number of services a bank provides a firm, the greater the availability of finance. Thus universal banking may lengthen and widen bank-firm relationships.

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\(^{16}\) It may not be possible to lend profitably to small firms or distressed firms without charging an extremely distortionary interest rate. This is why subsidies may be warranted. Petersen and Rajan (1994 b) develop this point based on work by Mayer (1988). They also provide evidence as do Calomiris and Himmelberg (1993).

\(^{17}\) This may account for how universal banks in Germany "support poorly capitalized mid-size companies ... that would not otherwise be bankable" (see Saunders and Walter (1994)) and how universal banks have been willing to carry out restructurings following war or economic collapse in Germany (see Calomiris (1993)). An explicit equity interest in the firm may also substitute for the implicit contracting involved in a banking relationship. Thus the availability of funds to small or distressed firms may increase if banks are allowed to hold equity (see the discussion in Petersen and Rajan (1994 b)).
which can enhance the availability of finance to firms.\footnote{Berger and Udell (1994) find that relationships also reduce the price of finance to firms though Petersen and Rajan (1994 a) argue that the effect may be small.}

\textit{C. Stability.}

One of the main arguments against allowing banks into new activities such as underwriting or market making is the fear that this will undermine the stability of the banks. White (1986) does not find that banks undertaking securities activities in the 1920s were any more likely to fail than banks with no connection to the securities business. One reason for this finding is that the larger banks entered the securities business, and the larger banks failed much less often in the 1930s. It is also hard to believe that the securities business is any riskier than any of the activities banks are chartered to undertake, which is why this finding seems plausible.

More recently, some have raised concerns that banks, with the protection of the deposit insurance guaranty, may enter the riskier segments of the securities business. The focus of the concern is misplaced. The actual flow of funds between the commercial bank and its securities business can be limited by mandating firewalls.\footnote{While firewalls can restrict direct transactions between sub units, they diminish the incentives for sub units to co-operate only a little. Thus many of the advantages of universal banking discussed above can continue to be realized. But incentives to co-operate can also result in conflicts of interest vis a vis clients, a subject we will return to shortly.} Many of the abuses that are alleged to have occurred in the 1920s such as securities affiliates ramping up the price of their parent bank stocks in order to facilitate mergers can similarly be taken care with relatively simple and easily monitored restrictions. It is harder to protect against reputational spill-overs from one business to the other, but so long as regulators can adhere strictly to a policy of not permitting intermediaries to become "too
big to fail", there is no reason why banks should not internalize these costs.\textsuperscript{20}

But a universal bank may also be more stable than a specialized bank. Apart from the earlier discussed co-insurance provided by different businesses, there could also be diversification benefits. Episodes of disintermediation -- when firms bypass commercial banks and raise money directly from public markets -- will affect universal banks less because the decline in their lending business will be offset by an increase in their underwriting and placing business. This may have an important effect on bank stability for it reduces their incentive to shave on loan quality in order to maintain profits in periods of extreme disintermediation.

To summarize, there may be good reason to believe there may be gains in terms of efficiency and stability from universal banking. But we have little evidence for any of these effects. For instance, better bank-firm relationships should really benefit small firms. Yet casual evidence suggests that small firms in Japan have been largely ignored by banks. They have been courted only recently as the banks' larger loan prospects have gone directly to the markets.\textsuperscript{21} Similarly, we do not know if the fabled stability of the big German banks is because they are universal banks, because they have a substantial ability to manage earnings, or because they operate as a cartel and make monopoly profits. We, therefore, need more evidence on the benefits of universal banking.

### III. The costs of universal banking.

We now discuss some potential costs of universal banking. Since I have alluded to them

\textsuperscript{20} Of course, all this is predicated on a fairly sophisticated, impartial, and unintrusive regulatory system. While one can argue about whether the system in the U.S. can be described thus, it is certainly not representative of the regulatory apparatus in nascent economies. Also, these economies are far less well diversified in terms of the numbers of financial intermediaries, so that an increase in the number of activities a bank undertakes may, indeed, make it too big to fail.

\textsuperscript{21} See the Economist, December 8, 1990.
earlier, I will be brief. A universal bank's ex ante market power and its ex post market power over a firm may be higher than that of a specialized bank. In a specialized banking system, the intermediaries who provide access to loans (commercial banks), and those who provide access to public financial markets (investment banks) differ. To the extent that these sources of funding are substitutes, there is competition and the rents the intermediaries get are kept down. By contrast, a universal bank could be viewed as a horizontal merger between a commercial bank and an investment bank. Apart from the possible reduction in the number of competing intermediaries, the costs to a firm of switching its business from a universal bank to another investment bank (or universal bank) can increase. The increase in switching costs enables the universal bank to charge higher ex post rents which, in turn, reduce a firm's incentive to invest (also see Sharpe (1990) and Rajan (1992a)). Thus firms may be reluctant to borrow from banks in the first place and may rely more extensively on internal funding in a universal banking system.

It is also possible that the universal bank is less efficient at underwriting than its specialized

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22 There are at least two reasons for this. First, when all intermediaries are specialized, a firm which has been borrowing from a bank thus far and wants to issue in the market has to approach an investment bank. The investment bank does not suspect the firm of being a "Lemon" because it knows the firm's own bank cannot underwrite. Thus the costs to the firm of switching from bank borrowing to accessing the markets via another investment bank are small. By contrast, when a firm has been borrowing from a universal bank, switching costs are higher because any other investment bank (or universal bank) when approached will wonder why the firm's own bank is not underwriting the firm. The "Lemons" premium the firm has to pay is higher. This effect appears to be important even for large firms. Consider this example: Deutsche Bank is Daimler Benz's hausbank. In the Wall Street Journal (May 12, 1994), Hilmar Kopper, Chairman of Deutsche Bank's board argued that "whenever the auto-maker wants to issue new bonds or stock "of course we must lead-manage that...because if we didn't, the world would say [Daimler is cross with us]. That wouldn't be good for Daimler's business..."."

There is also a second reason for switching costs to increase. The universal bank which has been lending to the firm has a number of advantages over other intermediaries in competing for the firm's business. For example, it knows when the firm is ready for a public issue and can prepare the groundwork for it long before others. This preemptive investment may be a source of competitive advantage which deters others from competing for the firm's business. Peach (1941) argues that this advantage was an important reason for banks to enter the securities business in the 1920s. More recently, Merrill Lynch and First Boston have started making loans with the intent of "using the lending business to gain other assignments" (Richard Hanson, President, Merrill Lynch Business Financial Services quoted in the Wall Street Journal, June 16, 1994).
counterpart. If so, there are two additional effects. First, there may be a bias towards bank loans rather than public issues in a universal banking system. The reason, quite simply, is that the higher costs of switching to an independent underwriter, coupled with the universal bank's own inefficiency at underwriting will lead firms to continue borrowing from the bank long after they would have switched to public markets in a more specialized system.

Second, the all-in cost of funding for firms in a universal banking system can be higher. The reason is that the higher ex post rents universal banks can extract are not fully competed away ex ante. Intuitively, the inefficiency of rival universal banks at underwriting gives the bank a cover with which to convert ex post rents from lending into ex ante rents (see Rajan (1994 a)).

Clearly, if universal banking is a source of rents, banks have an incentive to adopt the structure. But if it is also inefficient, one might wonder why a bank does not convert to a specialized structure, lower costs, and attract a larger market share. One answer may be that despite their inefficiency on some dimensions, universal banks may be able to compete more fiercely than any specialized bank. For example, a universal bank may get margins from a number of services it offers

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23 For example, it could be argued that universal banks suffer from conflicts of interest: Consider a universal bank which makes a loan to a firm. If the firm subsequently falls on hard times and the loan is large relative to bank capital, the bank has an incentive to underwrite a public issue and use the proceeds of the issue to have its loan repaid. Since investors know of the bank's predicament, they will be chary of the issue and apply a substantial discount to its price. The end result is that the firm's cost of funding is higher than if it were underwritten by an independent investment bank. An extreme example of this is First Boston's attempt (in August 1989) to refinance the bridge loan it had made to Ohio Mattress with a junk bond issue. One could argue that since investors knew of First Boston's mounting inventory of bridge loans, they were reluctant to believe First Boston's certification. The issue had to be called off because of investor reluctance to buy at a reasonable price.

In a similar vein, Packer (1994) examines initial public offerings in Japan of firms in which venture capitalists have substantial stakes. He finds that issues underwritten by an investment bank in which its own venture capital affiliate has a significant stake tend to be underpriced significantly more than the average issue (the effect is economically important also).

24 The universal bank may also want to prevent a firm from going public in order to maintain its hold over the firm. If the firm does issue public securities, it can build a reputation independent of the bank's by honoring its claims regularly. Public listing may also attract analyst following and reduce the asymmetric information between the firm and other potential investors. All this may reduce the bank's ex post market power over the firm.
firms. Thus while competing for any one service, it has the leeway to adjust the margins on the other services downwards. By contrast, the specialized bank has only one margin to play around with. Despite providing some services less efficiently than specialized banks, the universal bank can compete more fiercely. This threat reduces the incentive for any bank to adopt the specialized form when its competitors are universal banks. To the extent that margins on underwriting are sizeable, the universal bank can afford to be much less efficient than a specialized underwriter but still make it unattractive for any such bank to enter. Obviously, all this relies on markets for different services (e.g., lending and underwriting) not being competitive, which may well be the case in an economy with underdeveloped institutions.

B. Agency problems, bargaining problems, and the soft budget constraint.

We have argued that in a universal banking system there is a tendency for a firm to be tied to one intermediary for much of its financing needs. The difficulty of exiting the relationship enhances the incentives of both parties to cooperate. But the relationship may become burdensome to both parties. Consider first the firm's perspective. Even if the bank does not charge rents for fear of killing the goose that lays the golden eggs (see Sharpe (1990)), the firm becomes dependent on the vagaries of the bank's credit policy stance for funding. Diversifying among multiple banks may not help much if the tightening in bank credit policy is systematic across banks -- as in a "credit crunch". If such contractions are caused by capital constraints (see Bernanke and Gertler (1987)) or by agency problems (see Rajan (1994 b)), the universal bank may also become more conservative in the kinds of risks it wants to undertake in underwriting. While firms in the U.S. tide over such episodes by increasing their funding from the market (see Wojnilower (1980) and Kashyap and Stein (1993)), they may be less able to do so in a universal banking system where the (now)
conservative universal bank controls access to the markets. We need more research on what causes contractionary episodes, and whether these episodes will be more, or less, likely in a universal banking system.

From the bank's perspective too, the relationship may become burdensome. One problem may be of escalating commitments. As the bank invests more in the firm, its reputation becomes more closely tied to the firm and it has an incentive to lend more in order to keep its prior loans from becoming non-performing. Furthermore, as it becomes more closely involved with the firm, it becomes harder to get outside investors (especially junior debt or equity) to come in. Not unrealistically, they would fear the bank would force management to take actions against their interest. The bank could eventually be the sole source of external financing for the firm. Its large stake will reduce its ability to take action against management. Moreover, anticipating that it will be bailed out, management does not have a strong incentive to stay on the straight and narrow. Thus universal banking could lead to softer budget constraints for firms.

The problems just outlined suggest that universal banks, while better diversified than specialized banks, may have a tendency to become more deeply involved in the troubles of client firms (the experience of Credit Lyonnaise deserves study). They may also tie private debt and public issue markets more closely, eliminating a source of funding diversification in the economy. These adverse effects on stability have to be contrasted with the positive effects of bank diversification that I discussed earlier.

\[\text{\textsuperscript{25}}\text{ For example, when First Boston sought to issue junk bonds in order to have its bridge loan to Ohio Mattress repaid, investors stayed clear of the issue, among other reasons, because it was difficult to ascertain how much protection bondholders would receive in case of possible event risks, such as a merger or other events that could affect bond prices.} \text{ Also see Brown, James, and Mooradian (1993) and Gertner (1991) for models of restructuring in such circumstances.}\]
IV. Whither Universal Banking?

We have outlined important costs and benefits of universal banking. Unfortunately, we do not know the relative empirical magnitudes of each, or how the effects interact, so what follows should be viewed only as reasoned speculation.

For an economy like the U.S. where bank lending is very competitive, as is underwriting and brokerage, and where a multitude of rating agencies and analysts follow firms, it is unlikely that intermediaries enjoy much ex ante or ex post market power. This suggests that universal banks cannot survive if inefficient. There is casual evidence of this. Investment banks who tried ineffectively to combine large scale lending (bridge loans) with underwriting have largely gotten out of the business, with some like First Boston having to be rescued by deep pocket parents. Similarly, financial supermarkets for individual investors like the ones that Sears or American Express attempted to create have also not proved very successful and are being broken up. But at the same time, commercial banks like Morgan Guaranty have set up securities affiliates while Merill Lynch and First Boston have set up affiliates to lend to small firms. It would appear that the free market can reliably sort out the efficient (and the stable) from the inefficient (and unstable).

Provided the U.S. government can credibly commit to not subsidizing intermediaries through a "too big to fail" policy, there is no need for legislation prohibiting banks from entering the securities business. The gains to banks from deregulation will largely come from a drop in funding costs (resulting from co-insurance and diversification), while the gains to firms will accrue from possible scope economies. But given the competitive environment, it is probably overly optimistic to expect banks and firms to form strong ties, or for U.S. banks to take the fabled long-term view once they enter the securities business.
Kroszner and Rajan (1994 b) provide historical evidence that in a competitive environment intermediaries voluntarily adopt the degree of specialization that maximizes efficiency. They find that correcting for ex ante measures of issue quality, offerings underwritten by the affiliates of commercial banks in the U.S. in the 1920s secured higher prices than offerings underwritten by bond departments of banks. They conjecture that a public concerned about the possibility of conflicts of interest (as evidenced by the debate after the Crash) might apply a lower discount to the prices of securities underwritten by the more arm's length affiliate than to the prices of securities underwritten by an in-house bond department. This would imply that the affiliate structure was more efficient than the in-house department. They find that almost all banks moved to underwriting via the affiliate structure in the 1920s. It is hard to point to any regulation that may have caused this movement, suggesting that the movement was voluntary and potentially driven by efficiency considerations. They also provide evidence of some banks explicitly staying out of the underwriting business for fear that it would compromise the advice they gave their clients.26

While all this suggests the introduction of universal banking in a competitive financial system with stable specialized institutions cannot have a substantial adverse effect on efficiency or stability, one cannot be so sanguine in a nascent economy. Many such economies are characterized by government interference in directing lending, few information gathering agencies, poor accounting and disclosure standards, weak or co-opted regulators, and few stable specialized intermediaries. There are huge ex ante and ex post rents in intermediation. While in some Eastern

26 In contrast to Kroszner and Rajan (1994 b), Puri (1994 b) argues that banks (and in-house departments) may have been better at underwriting informationally sensitive issues than investment banks (or arm's length affiliates) because the former may have enjoyed substantial scope economies in gathering information. Her arguments do not explain why banks concentrated on underwriting issues which were less informationally sensitive (where their comparative advantage would have been low) or why they moved from the department structure to the affiliate structure.
European economies, a modicum of competition is provided by foreign financial institutions, it is not clear that they are in for the long run. It is also quite possible that if they do indeed become a serious competitive threat, their activities will be restricted by legislative fiat.

Given these circumstances, it is not at all clear that these countries should adopt universal banking. Because of the paucity of public firm specific information in these economies, firms are already strongly tied to their creditors. Thus it is not clear that these ties need to be strengthened any more by universal banking -- in fact one could argue in favor of a little less coziness and a hardening of the budget constraint. What is needed is more disclosure, and more impartial public information producers such as rating agencies and analysts. But it is by no means clear that these will arise easily in a universal banking system. As I argued earlier, it is quite possible that universal banks have a bias towards lending to firms as opposed to underwriting public issues for them. The reduced volume of public issues may reduce the liquidity of public markets, reducing the need for information producing agencies, reducing liquidity even further, and increasing the bias towards loans...

By contrast, if these nascent economies start out with specialized banks, it is quite possible that the specialized institutions needed for liquid markets will not be crowded out by the specialized commercial banks. Once there are stable institutions providing competitive access to loans and the markets, it may make much more sense to allow universal banking.

While discussing the growth of nascent economies, it also important to pay attention to the political economy of regulation and de-regulation. The firms in such economies are usually too small to have much political voice, and also too small to attract foreign attention. Banks are typically the institutions with the largest free cashflow and hence the most political power. Unless the power
of the financial sector is split into factions with opposed interests right at the beginning, it may be very hard to pass any legislation limiting the power of the banks later. Thus while economists may complain about how hard it is to introduce universal banking in the U.S. despite its apparent economic desirability, it may be much harder to pass legislation that allows specialized institutions to spring up once universal banks are entrenched.\textsuperscript{27} It is perhaps not surprising that economies with strong cartelized banking systems have been forced to deregulate them only as firms in those countries have grown large enough -- to tap foreign markets, to be of interest to foreign intermediaries, and to have political voice (also see Roe (1994)).

There is much that is speculative in the above paragraphs. While this partly reflects the the paucity of research in this area, it also reflects a fundamental problem in the study of financial institutions. Institutions cannot be disassociated from the environment in which they are conceived. We cannot be entirely confident of replicating the experience of other countries and our own at other times when we transplant an institution.\textsuperscript{28} We can only identify key economic forces, but we cannot be sure of how they will interact, or what their magnitude will be. Thus the best advice that can be given to regulators on universal banking is "proceed, but with extreme caution".

\textsuperscript{27} There is, of course, a tension here that the reader would have noticed. Specialized commercial banks may have little ability to prevent specialized investment banks from offering their services to firms. But since they get very little benefit from the growth of markets, they have an incentive to oppose them politically. For instance, Japanese firms were restricted from issuing public bonds -- unless they met stringent conditions -- till the early 1980s (see Rosenbluth (1989) and Hoshi, Kashyap and Scharfstein (1990)). It was only after Japanese firms became large enough to issue abroad that these regulations were relaxed. By contrast, universal banks have a greater ability to crowd out the growth of specialized investment banks and rating agencies, but perhaps a lower incentive to do so since they can share through their securities activities in the growth of markets.

\textsuperscript{28} As an example of this, Gorton and Schmidt (1994) find that German banks do not appear to vote in their own interest the proxy votes they have been entrusted with by small shareholders. They argue that this finding (surprising at least to U.S. economists) may be because of the greater social consciousness of the banks in Germany.
References.


Puri, Manju, 1994 a "The long term default performance of bank underwritten securities issues"


