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UNIVERSAL BANKING

International Comparisons and Theoretical Perspectives

Jordi Canals

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CLARENDON PRESS • OXFORD
1997

Oxford University Press, Great Clarendon Street, Oxford OX2 6DP
Oxford New York
Athens Auckland Bangkok Bogota Bombay
Buenos Aires Calcutta Cape Town Dar es Salaam
Delhi Florence Hong Kong Istanbul Karachi
Kuala Lumpur Madras Madrid Melbourne
Mexico City Nairobi Paris Singapore
Taipei Tokyo Toronto
and associated companies in
Berlin Ibadan

Oxford is a trade mark of Oxford University Press

Published in the United States by
Oxford University Press Inc., New York

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Canals, Jordi.
Universal banking : international comparisons and theoretical perspectives / Jordi Canals.
Includes bibliographical references and index.
1. Universal banks. I. Title.
HG1601.C26 1997 332.1—dc20 96–34856
ISBN 0–19–877506–7
ISBN 0–19–877505–9 (Pbk)

Typeset by Graphicraft Typesetters Ltd., Hong Kong
Printed in Great Britain by
Biddles Ltd., Guildford & King's Lynn

Introduction

The drastic changes that have occurred in the banking industry in many industrial countries over the past two decades have had a tremendous impact on financial intermediaries.

The deregulation and disintermediation processes, the globalization of financial markets, the emergence of new competitors, and the introduction and application of new information technologies in the banking industry have led to profound changes in its structure, increased competition, and squeezed margins. As a result, banks are reconsidering their traditional ways of competing and are seeking to redefine their strategy and organization.

One of the challenges facing banks in the major industrial countries is the growing importance of capital markets which, with the emergence of new financial instruments, are replacing some of the banks' traditional functions as financial intermediaries.

The banks' response to these challenges has been varied. Some have opted for concentrating on the traditional retail business, others for controlling part of the transactions that take place in the capital markets. Finally, some banks are following the financial markets in their globalization process, seeking to internationalize their activities, either alone or in alliance with other banks. However well the banks following these strategies may do, it can be safely said that nothing is as it was in the banking industry.

This book tries to make a contribution in three areas regarding universal banks in industrial countries. First, many banks have figured out that the only way to survive in this changing industry is to become universal banks by integrating different financial businesses. This strategy has manifested itself in several decisions: diversification into other financial activities, diversification into non-banking or non-financial activities, mergers and acquisitions, internationalization of activities, and, finally, the adoption of new organizational structures that enable a response to a quickly changing market. We will discuss the challenges and risks that universal banks face in their diversification process, and suggest ways of handling the increasing complexity. Moreover, the analysis of the advantages of universal banks over specialist institutions is developed from the viewpoint of banks, not from the more usual perspective of non-financial firms or the growth rate of a country. For that purpose, we will adopt the approach of considering what a universal bank's corporate strategy should be and problems of its implementation.

Second, we will discuss the relationship between banks and financial markets in this context of deregulation and disintermediation. The questions we want to address are: Will financial markets capture all the financial intermediation activity? Can banks play a role in the increasingly sophisticated world of financial markets? Will banks exert control over financial markets?

Third, we will look at the role of banks in financing and influencing non-financial companies in industrial countries from the viewpoint of banks themselves, not from the perspective of companies. The particular model developed in each country in the past decades has a clear effect in banks' strategy and performance. We will discuss the nature and evolution of universal banking in three countries: Germany, Spain, and Japan. Although the universal bank model seems to be the dominant one in all three countries, the differences in each country's financial system single out a number of distinctive features.

The methodology we will use will be primarily inductive. We will combine academic contributions from the fields of industrial economics, strategic management and finance with the detailed study of real cases, mainly of European and North American banks. Some chapters (for instance, Chapters 4, 5, and 10) present a blend of theory, formal models, and real cases. Consequently, this book should be useful to both students and professionals of the financial system. The banks studied in detail include the following: Argentaria, Banc One, Banco Santander, Banco Popular, Banesto, Bankers Trust, Bankinter, Bank of America, Barclays, BBV, BCH, Chase Manhattan, Citibank, Crédit Lyonnais, Deutsche Bank, HSBC, Midland, Mitsubishi, Morgan Grenfell, Nationsbank, Prudential, Shearson Lehman, and S. G. Warburg.

This book is addressed both at scholars and managers who work in the financial services industry. It has been written in a non-technical way, although in some sections (Chapters 4 and 5, for instance) certain banks' decisions are modelled following a more formal pattern.

The structure of this book is as follows (see Fig I.1). Chapter 1 briefly discusses the profound transformations that have taken place in the international financial system in the last twenty years and the innovations that have had most significance for the banking business, and their impact on the banks' performance.

In particular, we ask whether these changes are transforming the nature of banking activities, and, if so, how banks should adapt to the new circumstances. In this chapter, our conceptual approach will be functional: we will seek to analyse the tasks and functions that a bank should be carrying out and its real possibilities of achieving success in an environment of stiffening competition.

This chapter also introduces the notion of financial model. By financial model, we mean the unique configuration adopted by the financial system in a particular country, paying particular attention to the roles and relative weight of the banks and capital markets. At one extreme, there are countries where bank financing predominates. At the other extreme, there are a few countries where financial markets play a greater role in financial activity.

Chapter 2 discusses in greater detail the various models that have emerged for the organization of the financial system. First, we will discuss the model based on financial markets as a means of channelling flows between saving and

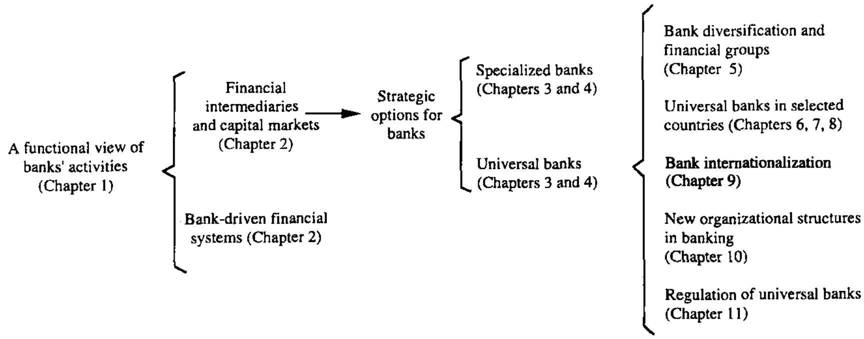

FIG. I.1 *Conceptual framework of the book*

investment. The second model is based on the pre-eminent role played by banks and other financial intermediaries. Unlike the first model in the bank-driven model financial markets play a much less prominent role in financing real investment. However, these two models, which are both deeply embedded in various countries, are not static but are presently undergoing a major process of mutation or change. This process seems to be tending to bring the two models closer together rather than differentiate or separate them.

Chapter 3 analyses, from a historical viewpoint, one of the banks' major strategic options at the present time: their transformation into universal banks. In the course of this analysis, we will briefly review the main arguments used in the United States—where commercial banks and capital markets were separated in 1933—with regard to the desirability of abandoning the universal banking model and separating commercial banking from investment banking.

However, the arguments used against universal banks in the United States, based on partial data, are not unequivocal. In fact, the banks that combined commercial banking with investment banking generally came out better from the crisis than those banks that confined their business to pure commercial banking. Therefore, looking at the issue in terms of profitability, number of banks failing, or solvency, the arguments do not support a separation of activities.

After discussing the separation of commercial banking from investment banking in the United States, Chapter 4 introduces the main arguments used to evaluate the theoretical and practical advantages and disadvantages of the universal bank system *vis-à-vis* specialized banks, from the banks' viewpoint.

The various arguments we will discuss—some of which have been extensively aired in the debates on the financial system or on public policy regarding the universal banks—are not fully conclusive in establishing the superiority of one bank model over the other. This chapter also presents a short discussion on mergers and acquisitions in the banking industry.

Chapter 5 will discuss two issues related to universal banks. The first is the diversification of the universal banks' activities towards other financial services.

Among the advantages of the diversification of activities, we will discuss—using real-life cases—the potential economies of scope between different financial services and the possibility of solving the capital markets' alleged information problems. We will then analyse a special case of universal banking: that in which the bank not only is involved in corporate lending, but also acts as shareholder. This is the situation in which the bank starts up a group of industrial or services companies whose core is the bank itself.

The next three chapters will discuss how the different role of universal banks, specialized banks, and financial markets has helped shape three financial models with some similarities but also with significant differences. These are the cases of Germany, Spain, and Japan. The reason why we have chosen these countries is that their respective financial models all have a common denominator: the major role played by bank financing in non-financial companies and the dominant presence of universal banks. It seems that the latter feature is slowly but surely gaining ground in many countries and an analysis from three different outlooks may be beneficial.

Chapter 6 analyses the German model. The widely held opinion that the presence of banks in German industrial corporations is highly important and positive for the country as a whole is based on a series of assumptions on bank financing and banks' control in non-financial firms. In this chapter, we will examine the validity of those arguments, using a detailed empirical analysis.

The Japanese model is analysed in Chapter 7. After outlining the main features of the Japanese financial system and its differences from the German system, we will discuss the role and importance of universal banks in Japan. In particular, we will analyse the concept of the main bank, its special relationships with non-financial companies, within business groups known as 'keiretsu', and their role within the framework of a financial system in which financial markets will play an increasingly important role.

Chapter 8 discusses the Spanish financial model. One cannot understand the involvement of banks in financing non-financial companies in Spain in the 1980s and 1990s without discussing two conditions that determine the framework within which the bank system operates in Spain: heightened competition within the industry and a situation of economic recession until 1984 and later between 1991 and 1993.

In general, we point out that relations between banks and non-financial companies in Spain are closer to the German model. The reasons for this are the significant weight of banks in the financing of companies and the smaller presence of some banks as leading shareholders of large companies. However, the Spanish model departs from the German model in one respect: the long-term bank debt of Spanish companies comprises only a small proportion of total bank debt.

After discussing the advantages and disadvantages of universal banks and their relative positioning in the three countries, in Chapter 9 we will analyse in certain depth another critical strategic decision for the banks: the internationalization of its activities. The globalization of the international financial system driven by financial markets seems to be also pushing the banks in this direction. After examining the various reasons in favour of or against bank internationalization, we will introduce a conceptual model that explains the internationalization of banks, based on both theory and real cases.

In Chapter 10, we will address a new critical issue for banks, particularly the universal banks: their organizational design. In particular, we will focus on multidivisional organizations and the model that has already been popularized as federated banking, based upon a federal organizational structure. None of the organizational solutions we describe is ideal for restructuring financial groups and adapting them to the new competitive situation. Each of these solutions could be applied with varying degrees of success depending on the bank group's history, the dominant styles and cultures, the resources available, and the weight of each of its business units.

Chapter 11 discusses the challenges that the financial regulators of industrial nations now face as a result of financial innovation and changes in the strategy of financial intermediaries. Generally speaking, the need for commercial banks to enter new businesses, given the decreasing importance of traditional financial intermediation, has led to a review of the means for regulating bank activity. This review has affected—and continues to affect—the separation of the classic financial intermediation activity from other activities, primarily securities trading and interests acquired by banks in other companies, whether these be financial companies—for example, insurance companies—or non-financial companies—other industrial or services companies.

Chapter 12 presents both a summary of the main conclusions and some final reflections on the management of universal banks and their role in a modern financial system.

Many colleagues and bank managers contributed to this book with their time dedicated to the author and their valuable comments and suggestions. In particular, I want to thank for their many comments on specific chapters and sections of the book Eduard Ballarín (IESE), Jordi Gual (IESE), David T. Llewellyn (Loughborough University), Joan Enric Ricart (IESE), and Rafael Termes (IESE). Dwight Crane (Harvard University), Sam Hayes (Harvard University), and Don Lessard (MIT) also provided useful comments on some of the ideas discussed here. All remaining errors are the responsibility of the author.

Eulàlia Escolà and Carmina Valiente helped the author in editing efficiently the different drafts of the book.

IESE's International Center on Financial Research (CIIF) also contributed to this project. Special thanks go to Carlos Cavallé, Rafael Termes, Natalia Centenera, and all the sponsoring companies.

I also want to thank David Musson and María Cifuentes. David Musson (Oxford University Press) played a key role in shaping the content of the book and encouraging the author through the process. María Cifuentes (Alianza Editorial) was very enthusiastic about the book from its inception and made possible quick publication of its Spanish version.

A special thank you goes to Jenni Scott and the rest of her team at Oxford University Press for their outstanding editorial help.

Barcelona, December 1995

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