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Consequences of Deregulation for Commercial Banking

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ABSTRACT

In recent years, many of the restrictions on banking activities adopted following the banking collapse of the 1930s have been eroded by improvements in technology and high interest rates, which led to increasing direct competition from unregulated institutions. Beginning in the 1970s, the regulatory agencies, state legislatures, and the Congress have moved to liberalize these restrictions. Based on research on economies of scale and scope, the experience of the conglomerate merger movement of the 1950s and 1960s, the observed effects of changes in state laws governing branches and holding companies, foreign experience, and experience in other industries that underwent deregulation, banking deregulation is likely to lead to reductions in the number of banks and increases in their efficiency, geographic scope, and product diversification. Such an outcome is consistent with the survival of a large number and variety of financial institutions and need not endanger the safety of the banking system.

OVER THE PAST TWO decades the markets for financial services have provided a fascinating laboratory in which to observe the interplay of market forces, political responses to crises, and the maneuvering of interested parties in shaping public policy toward an entire industry. In the process, a regulatory framework put in place a half century ago has been partly dismantled and is likely to be modified further, perhaps even more dramatically, in the years to come. This paper reviews the progress of deregulation to date, attempts to discern its implications for the future shape of the financial system, in particular commercial banking, and poses several questions of public policy.

I. Summary of Recent Developments

A. *The Legacy of the 1930s*

The current organizational and regulatory structure of the financial services industry, broadly defined, is one of the major remaining legacies of the banking collapse and depression of the 1930s. The diagnosis at the time was that the bank failures had resulted in large measure from excessive competition in combination

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with managerial errors and abuses. Thus, the Banking Acts of 1933 and 1935 introduced a large array of restrictions on banking designed to shelter banks both from excessive competition and from the errors and poor judgment of their own managements. With the advantage of hindsight and the results of a number of studies of the causes of the depression and the banking crisis completed over subsequent decades, one can conclude with some confidence that the diagnosis and cures adopted in the 1930s were, for the most part, incorrect and inappropriate.

B. The Revival of Competition

Whether based on a sound diagnosis or not, the regulatory structure put in place at that time survived largely intact for half a century. The decades of the 1960s and 1970s, respectively, corresponded roughly with two evolutionary stages in regulators' responses to the problem posed by progressively more binding regulation as the economic and technical environments changed rapidly.[1] In the 1960s, banks found themselves increasingly squeezed by deposit rate regulations and restrictions on activities that hindered their pursuit of profitable opportunities. Their response was to seek ways around the regulatory obstacles. The result was the now familiar "regulatory dialectic" in which the regulators responded by trying to plug every new leak in the dike of regulation as it opened up, only to find a new leak elsewhere [21, 22]. By the end of the decade, the regulator's task had become increasingly difficult.

Regulation in the 1970s, by contrast, was characterized by a policy of accommodating competition and expansion as far as current law permitted. Even so, regulation tended to lag developments in the financial markets, and much effort was spent simply in bringing regulation *de jure* into alignment with the situation *de facto*. The states played a leading role in the development of this new regulatory attitude, beginning with Massachusetts' 1972 authorization of the offering of NOW accounts by mutual savings banks. Belatedly, they were followed by the federal regulatory agencies and the Congress.

Pressured by a judicially established deadline to validate the regulatory agencies' authorization of NOW accounts and by a near-crisis in financial markets in the Spring of 1980, the Congress enacted the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 [14]. Only two years later, an intensification of the distress in the thrift industry led to the enactment of the Depository Institutions Act of 1982 (Garn-St Germain Act), which extended and accelerated the process of deregulation [15].

C. The Current Situation

The financial system is still in the process of digesting the changes that have already occurred. So far as prices paid and charged by depository institutions are concerned, deregulation has nearly run its course. Geographic expansion is still restricted by the McFadden Act and the Douglas Amendment to the Bank

[1] In two earlier papers [24, 25] the authors have reviewed the clash between the organizational and regulatory structure of the financial services industry inherited from the 1930s and current economic and technological realities.

Holding Company Act, but these restrictions have become less and less meaningful as banks have used nonbank subsidiaries of bank holding companies, loan production offices, Edge Act corporations, toll-free telephone numbers, brokered certificates of deposit, and other devices to serve customers over wide areas. Product line restrictions also remain, but are breaking down under the pressures applied by nonbank entrants into services formerly provided by specialized institutions and by the recent legislation enlarging the asset powers of thrift institutions, although many legislative battles remain to be fought. Entry, at least in a *de facto* sense, has become progressively easier, though explicit legislative liberalization of bank chartering restrictions has been undertaken by only a few states.

II. The Future: Product Specialization or Diversification?

One clear consequence of the steps toward deregulation taken so far is that financial institutions are free to engage in a much broader range of financial activities than was the case before. Economic forces, including any complementarities of either production or demand, can be expected to play a greater role in the future in determining the extent to which institutions specialize in one or a few services or diversify into many. Some inferences regarding the existence and importance of such complementarities (economies of scope) can be drawn from observations on the past behavior and success of both financial and nonfinancial firms that enjoy at least some freedom to choose their product lines.

A. The Evidence on Nonfinancial Conglomerate Mergers

One source of evidence is the conglomerate merger movement involving basically nonfinancial firms during the 1950s and 1960s. In interpreting the intent and impact of conglomerate mergers, it is necessary to distinguish three types: product extension, (geographic) market extension, and pure conglomerate mergers. Product and market extension mergers have some horizontal and vertical elements; the rationale for pure conglomerate mergers is much less clear.

A number of studies attempted to determine the profitability of mergers in the post-World War II period [18, 19, 20, 34]. While these studies considered all types of mergers, they included a large number of pure conglomerate mergers. Their common finding, despite differing samples and methodologies, was that the effects of mergers on the combined firm's profitability, as measured by returns to stockholders, were at best neutral. The only debate seemed to be whether mergers have a neutral or negative impact on profitability. These studies also concluded that, on average, the owners of acquiring firms lost from mergers, while the owners of acquired firms gained.

There have been a few attempts to determine the effects of conglomerate mergers on society at large, as opposed to simply the firms and shareholders involved. One study [40], though finding no evidence that conglomerate mergers are beneficial to society, also did not find evidence that they are harmful. More recently, Brozen [8, 9] has argued that conglomerate mergers do provide economic benefits to society. He concluded that acquired firms have returns that are generally below the average for all firms and, if not acquired, would either go out of business eventually or would continue to waste resources through relatively inefficient production or distribution systems. According to Brozen, acquisition of these firms results in expansion of capacity or maintenance of capacity that would otherwise contract; therefore, competition or competitive intensity is greater than it otherwise would have been.

B. Financial Conglomerates

Financial conglomerates have received a great deal of publicity in recent years, largely due to the mergers in 1981 between Prudential Life Insurance and Bache, between American Express and Shearson, and between Sears and both Dean Witter and Coldwell-Banker and the acquisition or establishment by a number of nonbanking-based firms of consumer or "nonbank" banks.

The attention centered on these and other comparatively recent cross-industry mergers, acquisitions, and affiliations has led many to believe that the interest of nonbanking-based firms in banking is of very recent origin. However, such a belief is false, because nonbanking entities have long had a significant presence not only in lending to businesses and households, but in many other financial services as well. Roughly a decade ago, for example, Cleveland Christophe [10] documented the penetration of 11 nonbanking-based firms such as Sears, General Motors, and General Electric in the consumer lending areas traditionally thought to be the domain of commercial banks and consumer finance companies. More recently, several studies published by the Federal Reserve Bank of Chicago [35, 36, 37] have updated and extended past studies of the extent of overlap between commercial banks and nondeposit-based firms in consumer and business lending and in the generation of deposit-like liabilities. These studies examined over 30 nonbanking-based companies and compared them with the top 15 bank holding companies and the consolidated commercial banking system.

A major conclusion of the studies was that the nonbanking-based companies have significant overlaps with commercial banks. This competition is not so much a case of the nonbanks invading the territory of the banks as it is of the nonbanks trying to maintain market shares established several decades earlier. With the exception of short-term commercial and industrial lending and the issuing of demand deposits, commercial banks are the Johnny-come-lately on the financial scene.

Despite the prominent examples of success, notably those of Sears, General Electric, and the major automobile manufacturers, casual and anecdotal evidence suggests that financial conglomerate combinations may not have been any more successful, on average, than their nonfinancial counterparts. The most dramatic recent example is Baldwin-United, which in 1967 was an old-line (dating back to 1862) manufacturer of pianos and organs with total assets of $67 million. Within a brief 15 years it skyrocketed to a financial conglomerate with $9.4 billion in assets. Then, early in 1983, the company declared insolvency and began to spin off its subsidiaries. There have been many other unsuccessful efforts to put together financial conglomerates, but their stories were less dramatic.

No obvious pattern emerges from this experience, in the sense that no particular combinations of activities can be clearly shown to be more conducive to the achievement of synergies, or economies of scope, than others. Rather, it would appear that there is no obvious superiority—or inferiority—of financial services companies associated with conglomerates relative to independent companies of the same type. Success or failure appears to be much more a function of the particular managements and competitive situations of the individual firms.

C. Bank Holding Companies

Commercial banks can enter many financial activities directly or through the establishment of a bank subsidiary. To enter activities permitted under the Bank Holding Company Act, but not permissible for banks *per se*, they must form a bank holding company subsidiary. But, even for holding companies, activities must "be so closely related to banking . . . as to be a proper incident thereto."

How successful have bank holding companies been in diversifying their services? In terms of numbers, it appears very successful. A recent survey reported that in 1982 bank holding companies operated some 7,840 nonbank offices in states other than the ones in which they were headquartered. The services offered by the largest number of these offices were finance company-type services, followed by insurance agency activities for smaller companies, underwriting credit life, loan servicing, mortgage banking, and community-type investments [46]. In addition, of course, these holding companies operate many in-state affiliates. The little hard research that has been conducted on these operations casts doubts on their success in increasing profits or decreasing risk. Two studies reported that mortgage banks affiliated with bank holding companies in the mid-1970s were both less profitable and slower growing than their independent counterparts [31, 42]. It was also found that bank-affiliated finance companies were less profitable than independent finance companies, although they expanded more rapidly [33, 42]. Similarly, bank-affiliated equipment leasing firms were less profitable than their independent counterparts [32].

Nor have commercial bank holding companies appeared to be any more successful in reducing their overall risk through affiliation with nonbank activities [7]. The conclusions of all of these studies, however, are limited by the restrictions on the type of nonbank activities bank holding companies may conduct [41]. Increased authority to enter into additional areas may permit bank holding companies to search out activities whose income flows are less positively correlated with, or independent of, their current income flow. But it should be kept in mind that the potential risk reduction from diversification by banks is ultimately quite limited, given the fact that the typical bank already holds a highly diversified asset portfolio.

D. Foreign Experience

A largely untapped source of useful information on the likely effects of further product deregulation is the experience of other countries with less restrictive regulation of financial institutions. Any conclusions based on international comparisons must be drawn with great caution and some skepticism, given the importance of cultural and other nonquantifiable variables in affecting the outcomes of similar policies in different countries. Nevertheless, there are some broad lessons to be derived from foreign experience that would appear to have relevance in virtually any country.

One fairly clear generalization that can be drawn from other countries' experience is that, freed of legal constraints or administrative pressures, many of the larger banks would diversify further than has been the case in the United States. Such diversification would involve a variety of investment banking functions, such as underwriting and trading the complete spectrum of corporate securities, including stocks, and the purchase of equity interests in nonfinancial firms. The strongest argument that this would occur under deregulation is that in West Germany, where it is permitted, such "universal banking" is in fact practiced, at least by the largest banks. Similarly, both U.S. and Japanese banks engaged in underwriting until prohibited from doing so, the former by the Glass-Steagall Act of 1933 and the latter by legislation adopted during the U.S. occupation. Moreover, in England, where informal regulation by the Bank of England had effectively separated commercial and merchant banking, the relaxation of that separation since 1971 has resulted in the rapid entry by the major clearing banks into securities underwriting and investment management [11].

III. The Future: Size and Geographic Scope of Banking Organizations

A. Economies of Scale

A lowering of entry and geographic barriers would allow the number, size distribution, and geographic scope of financial institutions to be determined much more by market forces, including the relationship of efficiency to bank size and organizational characteristics and customer preferences regarding price, quality of service, and convenience, than is the case today. There is a considerable literature on economies of size and organization that should offer some guidance. Some disagreement in results is evident in the literature on economies of scale at both the plant and firm level in banking. However, there has been a steady improvement over the past two decades in the measures of output, choice of functional form, and specification of branching effects. The more recent and better conceived studies appear to agree that: (1) there are significant economies of scale to be achieved by output expansion at the plant level for very small banking offices, (2) these tend to be exhausted as the office reaches a size around $100 million in deposits, after which costs remain flat or begin to rise; and (3) economies of multiplant operation appear to be negligible [4, 5].

On the basis of a reading of these results, several authors have concluded that the dismantling of barriers to interstate branching would have a relatively small impact on the U.S. banking structure, except possibly on banks in the smallest size class [29]. A major objection one might raise to such a conclusion is that it is based exclusively on operating efficiency. If customers value being able to transact business with their bank at more than one location, or if branching enables a bank to reduce risk by broadening the geographic diversification of its loan portfolio and/or sources of funds, or if greater size at the level of the firm enables the bank to reduce the transactions costs of managing its reserve position

[17], overall efficiency may require banks larger than would be justified simply on the basis of operating economies. Moreover, the fact that cost curves have been found to be relatively flat beyond the minimum point is consistent with a wide size range of efficient banks.

Another largely unanswered question is the effect of technological progress, particularly in data processing, on the optimal size of bank. It has often been assumed, usually uncritically, that such change would greatly increase the minimum size of bank needed for efficient operation. However, recent trends have been mostly in the opposite direction with the development of time sharing and smaller and less expensive computers with increasingly greater capabilities [25, 28].

B. *Effects of Liberalizing State Laws*

Some useful insights into the effects of geographical deregulation on banking structure can be gained by looking at the results in states that have liberalized their branching or multi-bank holding company laws. An early study of this type by Bernard Shull [39] examined the experience of banks in New York and Virginia after both states liberalized their branching and multi-bank holding company laws in the early 1960s. About ten years after the changes in state law, Shull was able to observe the following effects statewide: the rate of consolidation increased, concentration increased, and the number of banking organizations declined. At the local market level the results were quite different. There was no systematic effect on the number of banking organizations in local areas and, on balance, concentration declined slightly.

Other studies have found even less evidence of changes in concentration due to bank holding company expansion. In recent decades, concentration in banking declined at the national level, was virtually unchanged at the state level, and, with many exceptions in individual markets, declined at the local level [38]. To be sure, the number of banking organizations statewide has declined in most states liberalizing their branching and holding company laws, but this is of significance only to the degree that such theories of mutual forebearance as the "linked oligopoly" theory are valid. So far this has not been demonstrated [45].

C. *Foreign Experience*

As in the case of product diversification, the experience of foreign banking systems subject to varying degrees of regulation can tell us something about the likely consequences of removing geographic restrictions. It is generally known that the banking systems of virtually all other modern industrial countries are much more highly concentrated than that of the United States. Many have only a handful of banks of any consequence. In virtually all of these countries, the major banks operate nationwide branching systems. Consequently, it is tempting to conclude that removal of geographic restrictions in the United States would lead to a banking structure similar to those of other industrial countries.

However, such a conclusion ignores several important differences. One is the sheer size of the U.S. banking system, which means that even with a number of banks of comparable absolute size to those abroad, the concentration level would be considerably lower. Secondly, the large average bank size and high concentration levels typical of most foreign banking systems are only partly due to liberal branching laws. In many cases, as in Japan [44], Italy [1], and Canada [30], they are exacerbated by restrictive chartering policies and systematic encouragement of mergers. Thus, the high levels of banking concentration in other countries are as much a reflection of regulation as is the extreme atomization of U.S. banking. A banking structure determined entirely by market forces would probably lie between these extremes.

D. The Experience with Food Retailing

Banking, defined broadly to include other depository institutions like savings and loan associations and savings banks, is among the few industries in which the extent of branching is restricted. Food retailing is another industry that was once subject to concerted efforts to restrict multi-office operations. Because these efforts failed, the subsequent experience of food retailing may provide some indication of what can be expected to occur in banking if branching restrictions are removed. Following the rapid growth of chain stores early in this century, there were several unsuccessful attempts to restrict them in the 1920s and 1930s through, first, state and then national legislation [25, 27]. In part because of the depression, the growth in chain stores slowed, easing the pressures for legislative action. After World War II, the opposition to chain stores declined significantly and their share of the market again increased before leveling off. Increased demand for convenience and personal service associated with rising incomes, as well as the development of purchasing cooperatives and franchise operations, has enabled independently owned food stores to maintain a significant portion of the market. To the extent that the experience of retailing is relevant to banking, it suggests that deregulation may be compatible with the continued existence of a large number of banks of varying size. Indeed, this conclusion is buttressed by the resurgence in the chartering of new banks in California, Oregon, and other western states after years of domination by a few giant banks with statewide branching systems.

IV. Deregulation and the Safety of the System

Deregulating a previously regulated industry involves changing—at times, quite abruptly—the rules of the game under which management, owners, and labor have been playing. Moreover, as is evident from the recent experiences of the airline, securities brokerage (after the demise of fixed commissions), trucking, and telephone industries, these changes may also be disruptive for consumers. Not only do prices change more frequently, but the number of different prices for apparently similar services increases greatly—although, on average, they tend to be lower than before deregulation.

Another likely consequence of the increased competition resulting from deregulation is that certain services and even complete firms may disappear. Indeed, exit of individual firms through either merger or closure appears to be a characteristic of deregulation in many industries. Such exit need not, however, imply a reduction in the overall number of firms in the industry, as the entry of new firms—which is frequently the cause of the exit—could offset or even more than offset the number of leaving firms. This has been true in the airlines industry, which has more airlines today than before deregulation. It may also be true in the securities brokerage industry, an industry similar in many respects to commercial banking, which underwent price deregulation earlier.

But even if the number of firms in an industry declines following deregulation, the resulting churning of firms increases the competitive intensity of the industry, which is a major objective of deregulation. Market shares are reallocated both among existing firms and among old and new firms. In addition, if deregulation is successful in achieving increased efficiency, the size of the market may be enlarged.

A. The Key Role of Exit

Exit plays a key role in any competitive industry. It is the ultimate stick that complements the carrot of profits in disciplining firms to serve the public interest. However, it is effective in fulfilling this purpose only to the degree that it provides the proper incentives to the owners of the exiting firms. To do this, it must punish stockholders for the managerial errors, inefficiencies, or excessive risk-taking that were ultimately responsible for the exit. Or, in cases where the exit was due to a shift in demand or some other exogenous development that resulted in excess capacity in the industry, it must signal to others that the industry is not a prime prospect for new entry and that resources could be put to better use elsewhere.

In banking, unfortunately, the nature of regulation has often worked to prevent exit from performing its intended function. Regulation of banking has differed in a fundamental way from that of most other regulated industries, in that the well-being of the overall banking system was believed to be dependent on the financial health of every individual bank. Consequently, bank regulation has been directed primarily toward preventing or containing bank failures.

Although the introduction of FDIC insurance broke the linkage from the failure of an individual institution to the endangerment of the system as a whole [43], bank regulators often appear to act as if this linkage still existed. Indeed, some regulators have publicly and explicitly stated their fears that insolvency of large banks would endanger the system as a whole. Both the FDIC, through its policy of merging failing institutions, and the Federal Reserve, through providing exceptional assistance to large banks to maintain their solvency, have acted to cushion the effects of exit.

Such procedures are inconsistent with the therapeutic and disciplinary roles of exit. If the regulators remain reluctant to see exit by closure, then it is likely that they will act to offset some of the implications of deregulation of prices, products, and geographic location that has been or is being enacted by the Congress by constructing a safety net under, at least, larger individual banks.[2]

[2] At least one former regulator, however, believes that bank failure is important for deregulation and efficiency. Thomas Vartanian, a former general counsel of the Federal Home Loan Bank Board, argued:

> Without failure there is not going to be any ability to succeed. Otherwise, we will be regulated back to the mediocrity that has been the hallmark of financial institutions and that business over the last fifty years." [16]

One of the reasons for regulators' reluctance to move quickly to deregulate banking derives from a basic flaw in the current system of federal deposit insurance. Because present insurance premiums are scaled proportionately to each bank's total domestic deposits, banks are able to acquire insured deposits at the risk-free rate—regardless of the amount of risk they assume. This encourages banks to move out on their risk preference functions. The salutary effects of market discipline can be reintroduced by scaling the insurance premiums to risk in the same manner as the market would have done in the absence of federal insurance, thereby discouraging excessive risk-taking [6].

Achievement of the socially beneficial effects of exit is not inconsistent with the sale of a failed bank's assets to other existing banks, so long as the previous stockholders bear the consequences of failure and the purchasers are not direct competitors. To some degree the FDIC has managed to achieve the benefits of exit in its management of purchases and assumptions. However, the benefits have been limited by the extremely restricted group of institutions allowed to bid for the failed bank's assets. Existing geographic and product line restrictions have often limited bidding to similar institutions competing in the same market. To some degree these restrictions have been eased by the emergency merger provisions of the Garn-St Germain Act. It would be helpful if states that do not permit statewide banking would follow Indiana's lead by permitting a bank that is in a weakened financial condition to be acquired by banks that otherwise could not branch into that geographical area. But the complete elimination of such restrictions to allow a more open bidding procedure would do much to dissipate any possible anticompetitive effects of such forced mergers with existing institutions, as well as assuring that the assets were obtained by the owners willing to pay the most for them and, presumably, best able to manage them.

B. Alternative Forms of Entry and Exit

Entry and exit can occur on a more limited scale that does not entail the disappearance of an entire firm. A bank can abandon one of its many product lines that is not profitable, or a new firm or branch of an existing firm can enter a market by offering a single product or a narrow range of related products such as consumer loans. A hallmark of deregulated industries is the entrance of new tiers of specialized firms that offer narrow ranges of products: one tier that provides low cost, no frills service, such as Peoples Express in the airline business or the money market funds in the liquid investments business, and a second tier that specializes in high value added services tailored to the individual needs of particular customers or groups of customers.

Some new production and delivery systems may be described, for lack of a better term, as "mutants." This word connotes a strong element of randomness or unpredictability of outcome. Making forecasts regarding future mutations is more difficult than making forecasts about hybrids, which are usually designed, as opposed to occurring by chance. An example of a mutation is provided by the linkage of Paine Webber, a large brokerage firm, with a nationwide network of bank-owned automated teller machines run by Mastercard International that will allow Paine Webber's customers to draw cash from their cash management accounts. The Master Teller network is itself a hybrid of a credit card and a teller machine. Although these forms of entry need not always involve a change in the number of institutions, the competitive environment following such entry is changed.

Not all mutants survive. A few may displace some of the existing forms of organizations that provide financial services. For some period, both the mutants and the full-service, old-line commercial banks will exist side-by-side, just as horse-drawn carriages and automobiles shared the same city streets and country roads for over 30 years. Moreover, some of the mutants that do not survive may be sufficiently strong for a short period of time to cause the demise of many old-line, full-service banks, only to be themselves eliminated by a new mutant. More research needs to be focused on forms of entry and exit. The paucity of literature cited in this section of the paper bears witness to this observation.

V. Remaining Policy Issues

A. Concentration

Deregulation of pricing, branching, and entry will do much to move commercial banking toward the status of other, essentially unregulated industries. This prospect raises a number of public policy concerns. One of the most persistent of these concerns is that regarding the appropriate merger and acquisition policy, if any, to apply to the financial services industry.

Recent empirical research and developments in the theory of industrial organization have raised serious questions about the viability of the traditional view. Renewed interest in the role of entry conditions has led to the development of the theory of "contestable markets", in which the existing number and size distribution of firms play a much less prominent role in determining performance—and, in fact, are viewed as being largely determined by performance [3]. Finally, it has been argued that the broadening of markets that is accompanying deregulation and technological change should reduce concern about the effects of mergers and acquisitions even when traditional antitrust criteria are used in evaluating their competitive effects. The validity of these new results and theories should be scrutinized closely before deregulation proceeds much further because their acceptance and embodiment in policy are likely to have extremely important—and, perhaps, irreversible—effects on the financial structure of the future.

B. Conflicts of Interest

A perennial concern of students of banking is the conflicts of interest that attend the combination of lending, underwriting, and investment management activities. Although anecdotal evidence exists that such conflicts are real, their aggregate importance can only be guessed at. Hence, there is little basis for assigning a value to the potential costs that must be weighed against any benefits to be derived from combining these activities—benefits which are themselves largely conjectural.

C. Aggregate Concentration

Whatever the evidence indicates regarding the effects of consolidation and diversification on competition, efficiency, and the management of conflicts of interest, many observers of industrial structure will continue to have serious misgivings about the desirability of a heavily concentrated financial system modeled after that of Canada, England, or—in particular—Germany. Fear and dislike of size for its own sake have a long history in the United States and are not easily assuaged by (often exaggerated) claims for the importance of economies of scale and scope. The seriousness of the danger that a few mammoth firms might dictate government policy or corrupt the political process overrides in many people's minds the reassurances of others that no evidence of such influence is to be found.

D. Separation of Banking and Commerce

Another key policy question is whether to maintain the long Anglo-Saxon tradition of separating banking and commerce. Whatever the wisdom of such a policy, its continuance presupposes a fairly clear demarcation between those activities that constitute banking and those that do not. However, the technological changes of the past few decades, combined with the resurgence of firms like Sears and General Motors into some bank-like services, necessitate a reexamination of the perennial issue of how to define a bank [12]. Efforts to list the services that banks may appropriately engage in run the risk of being rendered obsolete by technological or competitive developments. What is needed is a more general statement of the broad principles underlying the separation of banking and commerce that can be applied to the situation as it exists at any particular time. Ideally, these principles would be derived from a rigorous analysis of the social costs and benefits associated with various possible combinations of activities.

VI. Conclusions

In light of the very dramatic changes in the economic, financial, and technical environments since the time most banking regulations were initially imposed and the belief that the industry-wide solvency problem has been solved, deregulation is currently being undertaken to permit the financial system to operate more efficiently. What will be the net consequences of deregulation for commercial banks? As we have discussed in this paper, they are far-reaching and highly complex. The evidence strongly suggests that deregulation of product line restrictions will result in considerable diversification by commercial banks into services previously prohibited to them, as well as further expansion by nonbanking-based firms into additional financial services. However, the mixed success of both financial and nonfinancial conglomerates, the apparently poor performance of nonbank subsidiaries of bank holding companies, and the varying degrees of specialization by financial institutions, even in a country like West Germany that imposes few product restrictions on banks, all argue that there will continue to be a highly diverse set of financial institutions after deregulation.

The evidence from studies of plant and firm economies of scale and scope, the experience of states liberalizing their branching and holding company laws, and foreign experience all suggest that geographic deregulation will result in some degree of consolidation of the banking industry. These changes may be smaller than is often predicted, because much deregulation has already been accomplished, *de facto*, if not *de jure*. While further deregulation may cause near-term problems for consumers, inefficient bank managements, and policymakers, in the long run it will benefit well-managed banks and, in particular, consumers.

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DISCUSSION

ROBERT A. EISENBEIS*: This paper is an historical survey and policy oriented paper and is divided essentially into four parts. The first part provides a review of the financial system and its evolution, and it is basically a summary of descriptions that have appeared elsewhere (see for example the papers in the American Assembly (1983)). It does offer, however, a useful condensation of the reasons for regulating financial institutions, the evolution of financial regulation and the financial system as a whole, and the present status of financial reform legislation.

The second part of the paper raises very real management issues of whether the future of financial institutions lies in conglomeration or specialization. Review of the remarkably consistent and extensive literature from both the nonfinancial and banking sectors fails to demonstrate the benefits of conglomerate expansion, whether measured in terms of 1) risk reduction, 2) profitability, 3) returns to shareholders, or 4) economies of scale or scope. When evidence in banking is examined, the treatment is less complete, especially when compared with the review of the nonfinancial evidence. For example, several recent studies examining benefits to shareholders of conglomeration, including the work of Martin and Keown (1981), are overlooked. In addition, Humphrey (1983) has done a more recent review of the work on economies of scale which is broader in coverage and more conclusive than the authors suggest of the literature to date. Also not mentioned is the work on economies of scope of Gilligan, Smirlock and Marshall (1983).

The review is a bit uncritical and in the process passes up an important opportunity to point to new areas for further research. For example, the studies attempting to compare the performance of bank holding company subsidiaries with unaffiliated firms to make inferences about relative riskiness, profitabililty, etc. all assume that BHC subsidiaries operate essentially as independent firms and their financial statements capture their true economic performance. But it is well known that numerous ways exist to transfer income and assets among affiliates and subsidiaries. If bank holding companies operate essentially as consolidated entities then these comparative studies may be biased, moreover the direction of this bias may be unknown.

Finally, no guidance is provided on the questions posed in this section on whether the future lies in conglomeration or specialization. The key questions

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