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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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seem to be: What are the economic incentives pushing firms into conglomerization? Why will increased diversification result and what will be the effects on risk exposure. Why does there seem to be this drive in the financial service industry to obtain large size if scope and scale economies are small or nonexistent?

The third section of the paper examines public policy towards entry and exit in a deregulated environment and its relationship to safety and soundness. It points out that policy makers have not fully realized the power of deposit insurance system in eliminating runs and thus believe that soundness is assured by preventing failures. The authors correctly point out that with runs eliminated, risks to the insurance funds may be reduced by allowing some failures.

In this section the authors also seem to be arguing for a relaxation of the antitrust laws so as to facilitate exit since they believe that one of the adverse consequences of entry restrictions has been to reduce exit of unsound firms from the system. They look with some favor on the recent change in the Indiana law as a way to increase options for facilitating exit by increasing the number of bidders that could buy a failing firm. It is interesting, however, that in a recent case in Fort Wayne, Indiana, the new law was essentially irrelevant since the failing institution was sold to the largest firm in the market after first having been denied earlier on anticompetitive grounds. What carried the day was the existing provision in the bank merger laws permitting anticompetitive acquisitions to be consumated if they are outweighed by convenience and needs considerations.

The final section of the paper discusses the remaining policy implications of deregulation including: the implications of a massive consolidation of the banking industry as barriers to interstate expansion are relaxed and the concentration of financial resources that would accompany such a consolidation; the potential for conflicts of interest as the scope of permissable banking activities is expanded; and the long run effect of the erosion of the traditional separation between banking and commerce. These issues are foremost in importance in the public arena today and is where the public could benefit most from the authors' insights and analysis of the issues. Unfortunately, they choose to call for more research on these issues. The problem is that events may require policy decisions to be made before this research is conducted.

There recently has been a tendency among current policy makers to give the benefit of the doubt to the self interests of shareholders in weighing the potential benefits of conglomeration against the potential costs to the public in terms of the issues raised by the authors. What is commonly overlooked in the public debates so far is the lack of significant evidence, which the authors document, of efficiency gains, benefits to shareholders or benefits to the market. This lack of evidence of benefits might suggest giving higher weight to the potential costs than would have been the case if the benefits of product or geographic expansion were shown to be great.

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