Competition in the Financial Industry: Who Can Survive?

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Executive Summary

Many commercial banks regard computers and new communications technologies as a critical weapon in market competition as well as part of a close relationship with customers. Information technology is not limited to uses in the commercial banking industry. It has supported the expansion of capital market instruments, such as corporate bonds and commercial papers, and innovative financial products, such as mutual funds and pension funds, and thus helped them to make inroads into traditional commercial banking businesses. Nonfinancial firms have entered the business of credit cards and other financial services by establishing advanced computer systems and building on an existing customer base.

In both the United States and Japan, commercial banks' profits have been damaged by the deterioration of lending assets, rather than by a decrease in revenues owing to a decline in lending. Since 1992, U.S. commercial banks have rapidly recovered profitability, helped by the decline in the short-term interest rate, improvement in the quality of assets, and reduced operating costs. Because of the deterioration in wholesale lending assets during the late 1980s, many U.S. commercial banks are changing the nature of their business, shifting from wholesale to retail lending, expanding fee and trading business, or entering new areas, such as sales of securities and insurance. The U.S. commercial banking industry is consolidating through mergers and acquisitions.

In the United States and Japan, the players in the financial services industry often use the phrase "consumer benefit" both to attack regulations that protect a particular industry and in seeking to maintain those that protect the players themselves. In conflicts between different financial industries, regulatory authorities support and represent the interests of the industry they control.

In Japan, the expansion of innovative financial products and their impact on existing regulations may be minimal, especially when those products are regulated administratively, not just legislatively. The emergence of mutual funds has made ceilings on deposit interest rates obsolete, and, similarly, some financial products developed through the use of information technology can change or by-pass regulations to some extent. Providers and users of financial services increasingly demand the liberalization of corporate bonds, commercial papers, and other financial products.

To "protect" investors from risky financial assets and to protect the interests of individuals or small businesses as users of financial services, regulatory authorities in both the United States and Japan have proposed or imposed new rules. Taking the opposite view, many experts in these countries, including leaders in the financial industry and economists,

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Chapter One

Introduction

Recent developments in information technology and changes in regulations have changed the landscape of the financial services industry, especially in the United States.

Although commercial banks have actively used computer and communications technology in several areas of their business, new financial products, corporate bonds, and commercial papers, the expansion of which has been strongly supported by advanced information technology, have eaten away at commercial banks' market share both in lending and deposit taking. Nonfinancial firms also have entered into corporate lending, credit card loans, leasing, and other financial services. To compete with these entries into traditional commercial banking businesses, commercial banks also have entered new businesses, such as sales of securities and insurance.

The intense competition among different types of financial institutions has generally benefited consumers of financial services by providing various financial products at lower prices. However, it has also produced several public policy issues such as instability of the national financial system and the need for protection of individuals or small businesses. As the boundaries separating financial industries have grown vague, conflict among those industries has become serious.

To deal with the public policy issues and to ease the conflict among financial industries, regulatory authorities for financial services have proposed and executed several new regulations and deregulations, actions opposed by some players and welcomed by others.

This study focuses on the competition between the commercial banking industry and other financial intermediaries, such as security houses, insurance companies, and mutual fund groups, in order to analyze the impact of advanced information technology and changing regulations on the interests and behavior of major players in the financial services industry. Those players include commercial banks, other financial institutions, nonfinancial corporations that provide financial services, wholesale and retail users of financial services, and the regulatory authorities mostly in the United States and also in Japan.

Chapter Two reviews how commercial banks in the 1990s use information technology in their business and how they evaluate its importance, with examples of advanced computer systems used and evaluations of the results drawn from recent bank annual reports.

Chapter Three describes how nonbank and nonfinancial firms entered into and expanded their share of traditional commercial banking businesses such as fund gathering, wholesale lending, and retail lending.

Chapter Four examines trends since the 1980s in the commercial banking industry, which has faced intense competition from outside, through an analysis of statistics reported by the Federal Reserve Board and credit rating agencies.

Chapter Five examines three major issues in public policy and regulation, analyzes the ways different players in the financial industry try to move regulators, and who wins or loses because of modification or abolition of current regulations.

Chapter Six changes the focus to Japan to analyze financial regulations there, which are in many instances tighter than in the United States, and the behavior of major players governed by those regulations, to find which aspects are shared by the United States and Japan and where they differ.

Chapter Seven summarizes findings of the analysis made in this study.

Chapter Two

Information Technology in Commercial Banking

In the 1990s commercial banks use computer and communications technology in several areas of their business.

Initially commercial banks attempted to improve branch operations by creating advanced interbranch computer systems that connect all branches and handle various transactions with customers. The number of financial products offered by commercial banks has increased significantly since the late 1980s, when the banks were allowed to participate in new businesses such as sales of mutual funds and insurance. The increased mergers and acquisitions in the commercial banking industry in the 1990s expanded the branch network of a commercial bank and let the bank offer various financial services previously provided by multiple banks. Thus, in the 1990s the importance of those advanced computer systems is increasing in order to reduce operating expenses and provide better information to employees and customers.

Citicorp has reduced branch operating expenses by $300 million annually since 1990 by moving to common operational support systems: any branch in the United States can access a customer's total banking relationship, including deposit, borrowing, and counseling on investments, on presentation of the automatic teller machine (ATM) card.[1]

In 1992, as part of a systems enhancement project, NationsBank signed a five-year contract with Systematics Financial Services, Inc., to assist the bank in converting its broad product line, formerly offered by NCNB and C&S/Sovran (the two banks merged into NationsBank on December 31, 1991), to standard retail products throughout its multistate franchise. The conversion is expected to be completed by the end of 1995, and although the bank anticipates an initial increase in expenses during the period of conversion, it that to be offset by future benefits.[2]

Second, the introduction of computer and communications networks has changed the contact between commercial banks and their customers. Citicorp and other banks offer customers the option of doing nearly all banking by telephone.[3] Through ATMs depositors can deposit, withdraw, and transfer funds as well as purchase mutual funds at their convenience 24 hours a day.

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[1]Citicorp, Annual Report, 1992, 10.

[2]NationsBank, 1992 Annual Report, 30-31.

[3]Kelley Holland and Dean Foust, "Another Year in 'Bank Heaven'?" *Business Week*, Jan. 10, 1994, 103.

Not too many years ago, the Chemical Banking Corporation handled most consumer transactions through its branch system. In 1992, it handled some 190 million consumer transactions annually inside its branches, another 90 million through ATMs, and another 25 million through its 24-hour telephone service line.[4]

Third, commercial banks use information technology in making such decisions as whether to extend credit, in asset and liability management, and in marketing strategy.

Decisions to extend credit, for example, begin with the process of accumulating and analyzing data relevant to the applicant's creditworthiness. In the case of a consumer borrower, the information may be relatively brief, consisting of a credit application, a report from a credit bureau, and the results of a computerized credit scoring system. In the case of a commercial borrower, extensive information about the corporation and its industry may be required, and the credit quality of the borrower may be analyzed according to industry- or economy-wide computerized economic models.[5]

According to J.P. Morgan's 1992 annual report, the company's objective in managing its overall asset and liability portfolio is to maximize the total return, including the net interest margin plus realized gains or losses from investment securities, off-balance-sheet instruments, and asset sales, and changes in the present net value of the portfolio. Because assets, liabilities, and off-balance-sheet instruments (such as investment securities, loans, interest-bearing deposits, long-term debt, interest-rate swaps, and interest-rate options) undergo varying repricing and maturities, changes in interest rates may result in increases or decreases in net interest revenue as well as in the estimated fair values of such instruments. The bank actively monitors its exposure to interest rate risk and its liquidity profile and uses financial instruments, such as interest-rate and currency swaps, financial futures, and options to adjust its exposure in light of market conditions.[6] Without advanced computer systems that monitor the bank's various assets and liabilities, such close management would be impossible.

Banc One's "Strategic Banking System" is an example of how computer systems can be used in a marketing strategy. According to John B. McCoy, chairman and chief executive officer of Banc One,

> The Strategic Banking System, jointly developed with EDS of Dallas, is a complete bank operating system oriented to customer relations. By focusing on the customer, rather than on separate bank accounts, we

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[4]Chemical Banking Corporation, 1992 Annual Report, 14.

[5]Douglas Ginsburg, *Interstate Banking* (Cambridge, Mass.: Harvard University Program on Information Resources Policy, April 1982, P-82-4), 58.

[6]J.P. Morgan & Co., Inc., 1992 Annual Report, 28.

> can more effectively provide total financial service. In addition to being a state-of-the art operating system, it will integrate with our product profitability and household demographic systems to provide each of our banks with the best available information on complete customer relationships.[7]

In the fourth area, information technology enabled commercial banks to develop new financial products and enter new businesses such as fees and commissions business, securities trading, and foreign exchange and derivatives.

Credit cards are a product developed through information technology. Information technology is used extensively in credit control, transaction processing, and the collection of payments in the credit card business.

Other examples of new financial products are variable rate consumer loans (mortgage loans, installment loans, or revolving credit), which depend upon computer-generated indexes and programmable interest-calculating algorithms, and funds concentration services, which allow corporate customers to pull funds from different accounts in different places and send them to a central location for maximum overnight investing.[8]

State Street Boston Corporation is one of the most active players in the fees and commissions business and has the largest share of any U.S. bank in custodial service. In 1992 its fee revenue amounted to $703 million, while its net interest income was $296 million. For custodial service, a trustee or custodian is the entity responsible for keeping possession of a securities portfolio and tracking changes in its value. State Street's customers are large institutions (e.g., insurance companies, pension and mutual funds) that own many types of securities and are constantly changing their asset portfolios. Since the 1970s, State Street has been essentially a computerized record-keeping and accounting business.[9] In its 1992 annual report, State Street described itself as follows:

> Our role in servicing financial assets is to help our customers execute and control creative, global investment strategies that require the record keeping, reporting, analysis and related services we provide. Information technology is key to that role.[10]

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[7]Banc One Corporation, 1992 Annual Report, 4.

[8]Thomas D. Steiner and Diogo B. Teixeira, "Technology in Banking: Creating Value and Destroying Profits," Business One Irwin, 1990, 49.

[9]Steiner and Teixeira, "Technology in Banking," 211.

[10]State Street Boston Corporation, Annual Report 1992, 6.

J.P. Morgan has a strong position in both fee business and securities trading and in foreign exchange and derivatives. In 1992 its noninterest revenue, including $959 million in trading revenue, amounted to $2,950 million, while its net interest income was $1,708 million. Like custodial business, trading business requires a large investment in computers that update market prices, calculate traders' positions, and execute trading. According to Dennis Weatherstone, chairman of J.P. Morgan, "Every facet of our business depends on superior technology, a critical competitive weapon. While total expenses for the firm were up 15% last year, spending on technology and communications rose 20%."[11] The increase was primarily a result of technology to support its investment in trading business.[12]

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[11]J.P. Morgan & Co., Inc., 1992 Annual Report, 4.

[12]Ibid., 16.

Chapter Three

New Competitors and New Competition

For commercial banks, information technology is a double-edged sword. Just as they can use this technology in several areas of business, so nonbank financial institutions also benefit from new financial products developed through information technology and gain opportunities to enter the territory of commercial banking business.

3.1 Unbundling of Commercial Banking Business and New Entries

The business of commercial banking includes lending, taking deposits, fund transfers, and so on. Traditionally, these services were provided solely by commercial banks. The territories of different financial institutions such as commercial banks, investment banks, savings and loan associations, and insurance companies were clearly separated primarily by regulations, and the institutions rarely competed in offering the same service.

> In a world of expensive information, high transaction cost, and diverse and often conservative investors, these special roles gave banks and securities firms an advantage over other firms in providing the entire bundle of wholesale credit services.[1]

This structure, protected by regulations, guaranteed the commercial banks' interest-rate margin between lending and borrowing.

Recent developments in technology, the increasing sophistication of customers, and deregulation all have allowed the unbundling of these services and brought new entries on both the asset and liability sides of the bank balance sheet. "These new competitors were not subject to banks' restrictions and could cherry-pick the profitable customers and product lines. The increasingly easier and cheaper transmission of information (caused by technology) was fundamental in creating opportunity.[2]

Since the 1970s, most large corporations borrow their funds through bond and commercial paper markets instead of bank loans, and since the 1980s some of them compete with commercial banks even in the area of wholesale and retail lending through their financial subsidiaries. A large portion of bank deposits has been shifted to money market mutual funds, which have almost the same liquidity as bank deposits.

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[1] Lawrence M. Sweet, "Competition in Wholesale Credit Services," A Staff Study, Federal Reserve Bank of New York, May 1992, 98-99.

[2] Steiner and Teixeira, "Technology in Banking," 54.

As various kinds of corporations became engaged in financial services, changes and developments in the financial industry created a complicated competitive pressure against the commercial banks. For example, the development of capital market instruments such as corporate bonds and commercial papers influences the commercial banking industry in three ways (see **Figure 3-1**):

(*i*) provides corporations and consumers with alternatives for investments that compete with bank deposits;

(*ii*) provides corporations with alternatives for fund raising that compete with wholesale bank loan; and

(*iii*) provides nonbank financial institutions with low-cost funding methods, which give them an advantage in competing with wholesale or retail bank loans.

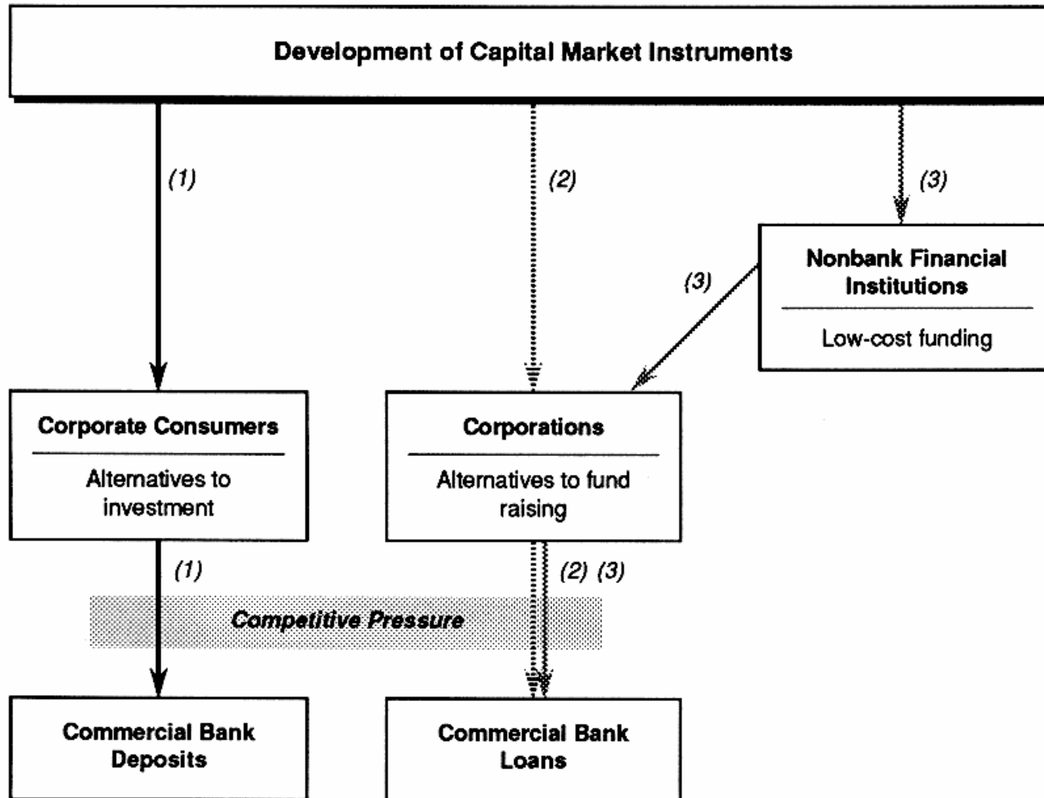
This chapter examines some areas of competition between commercial banks and other financial institutions in the United States, and analyzes trends and factors involved.

3.2 Competition in Fund Gathering

As shown in **Table 3-1**, the assets of pension funds and mutual funds have grown remarkably since 1950, while those of commercial banks, thrift institutions, and insurance companies have shrunk. Because both pension funds and mutual funds are invested in various assets such as stocks, bonds, and commercial papers, and the returns on those investments are distributed to a large number of shareholders, advanced information-processing technology has been critical to expansion in this area. Although pension funds compete with traditional life insurance products and other long-term investments, mutual funds offer more direct pressure against bank deposits as short-term financial products.

Until the late 1970s bank deposits were the only financial instrument both corporations and consumers could use to place their funds and withdraw them by writing checks. Deposit were insured by the Federal Deposit Insurance Corporation (FDIC). By Regulation Q of the Banking Act of 1933, commercial banks were prohibited from paying interest on demand deposits, and ceilings were set for time and savings deposits. This system, which guaranteed profits for commercial banks and the safety of bank deposits, was considered to have contributed to the stability of U.S. financial system for a long time.

In the 1970s increases in the market interest rate and the emergence of money market mutual funds began to shake the regulated financial structure. Money market mutual funds are a financial instrument that offers returns related to market interest rates through investments in short-term financial assets such as commercial papers, treasury bills, and certificates of



Note: The numbers in parentheses indicate three possible ways in which capital market instruments can put pressure on commercial banks.

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Figure 3-1

Impact on the Development of Capital Market Instruments

deposit. At the same time that money market mutual funds offered a higher yield as the market interest rate jumped, bank deposits, which had interest rate ceilings, became unattractive for depositors, who then shifted large amounts of funds from bank deposits to investments in money market mutual funds.

Thus, regulation of interest rates, which had previously protected the profits of commercial banks, became an obstacle for them in competition with new entrants. To meet such changes in the financial environment, Congress was forced to modify the legislation on interest rate ceilings. The Depository Institution Deregulation and Monetary Control Act (DIDMCA) of 1980 eliminated ceilings on interest rates for bank deposits and the Garn-

Table 3-1

Total Financial Assets of Intermediaries

	As of Year-End, in $ U.S. Billions				
Intermediaries	1950	1960	1970	1980	1990
Banks and Thrifts	190	346	757	2,336	4,912
Insurers	75	142	252	638	1,884
Pension Funds	12	58	172	668	1,868
Mutual Funds	3	17	47	104	1,078
Finance Companies	9	28	64	202	641
Brokers and Dealers	4	7	16	46	262
Assets of Intermediaries	293	598	1,308	3,994	10,645
	As of Year-End, Percentage of Total				
Intermediaries	1950	1960	1970	1980	1990
Banks and Thrifts	65	58	57	58	46
Insurers	26	23	19	16	18
Pension Funds	4	9	14	17	18
Mutual Funds	1	3	4	3	10
Finance Companies	3	5	5	5	6
Brokers and Dealers	1	1	1	1	2
Assets of Intermediaries	100	100	100	100	100

Source: Calculations by Federal Reserve Bank of New York based on Flow of Fund Statistics, Federal Reserve Board. Quoted in Richard Cantor, "The Institutionalization of Wealth Management and Competition in Wholesale Investor Services," Federal Reserve Bank of New York, A Staff Study, May 1992.

St. Germain Act of 1982 approved the development of Money Market Deposit Accounts[3] and super NOW (negotiable order of withdrawal) Accounts.[4]

[3]Savings accounts with no interest-rate ceiling. Rates are set by the bank. A seven-day hold is permitted on withdrawals; up to six preauthorized third-party withdrawals are permitted per month, three of which can be checks. Regulatory rules phased in minimum deposit requirements.

[4]Accounts that are a combination of the NOW account and the money market deposit account. A NOW account has a ceiling on interest rate payable, but a super NOW account does not, except when the average balance falls bellow a certain amount. Unlimited deposit and withdrawal transactions are allowed, although there is a rule on minimum initial and average balances.

As far as regulations of interest rates are concerned, deregulation seems to have been a consequence of competition rather than a cause of it. This is a good example of new financial products developed with new technology influencing the regulation of existing systems.

Traditionally, the deposit insurance system, which supported consumer confidence in bank deposits, was believed to be the reason that commercial banks could procure funds at a lower cost than uninsured financial institutions such as nonbank finance companies and money market mutual funds. Whether that system is beneficial for commercial banks or not depends on the level of premium the banks must pay. In less competitive circumstances, the amount of the premium was nominal, and with the burden of that small cost commercial banks deposits could guarantee reliability to customers.

With the collapse of the savings and loan (S&L) industry and the consequent increased failure of commercial banks, the level of the deposit insurance premium was raised so that the deposit insurance system could work without causing government expenditure. According to a banking law enacted in 1991, "the FDIC imposes a deposit-insurance premium averaging 24.8 cents per year (up threefold over four years) on each $100 of domestic deposits. One reason money-market mutual funds can pay depositors higher returns than banks can is that they don't face such expenses."[5] Just like regulations on interest rates, the deposit insurance system that protected the profits of commercial banks in years when competition was insignificant now sometimes works against those banks.

Even after deregulation of interest rates on bank deposits, the shift by customers from deposits to mutual funds continued. A number of money market mutual funds have become very competitive against bank deposits now that customers can withdraw funds by writing checks, although there usually are restrictions on balance. Under conditions in which everyone can move funds at low cost and easily obtain information on the yields of various investments, mutual funds, which have almost as many features as bank deposits yet offer higher returns, are a serious threat to commercial banks.

Nevertheless, stock and bond mutual funds, reflecting the recent surge in stock and bond markets, have shown more growth than money market mutual funds. In 1993, stock mutual funds attracted a record $128 billion, far above the previous record set in 1992 of $78 billion. The bond funds inflow of $114 billion in 1993 also set a record, beating that of 1986 of $109 billion. Assets of all mutual funds, including stock, bond, and money market funds, topped $2

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[5]Kenneth H. Bacon, "Banks' Declining Role in Economy Worries Fed, May Hurt Firms," *Wall Street Journal*, July 9, 1993, A5.

trillion at the end of December 1993.[6] (For a discussion of the risks involved in stock and bond mutual funds, see **Chapter Five.**)

As the competition between commercial banks and mutual funds heated up, friction occurred. According to the *Wall Street Journal* of August 9, 1993, the Investment Company Institute, a mutual fund trade group, stated that commercial banks had wrongly attacked a proposal by the Securities and Exchange Commission (SEC) that would permit marketing mutual funds through a so-called summary prospectus instead of a full prospectus. The objection made by the American Bankers Association (ABA) was that summary prospectuses do not provide full and accurate disclosure and do not provide adequate investor protection. This controversy symbolized the increased concern of commercial banks about the expansion of the share mutual funds of total financial assets of the United States and the intensified competition between commercial banks and mutual funds.

In another trend, commercial banks have grown more aggressive in selling mutual funds through their branches. About 3,500 banks now offer mutual funds, and a third of all mutual funds are sold through banks.[7] Some banks have begun to sell mutual funds through their ATMs.[8] **Table 3-2** shows the ten U.S. commercial banks that made the most in mutual fund advisory fees in 1992. However, overall this trend does not seem so favorable for commercial banks. According to Amy J. Errett, chairman of Spectrem Group, a consulting firm in San Francisco, "Banks can earn 2.0 percentage points more annually than the rates they pay on consumer CDs by reinvesting at higher rates. By comparison, banks typically can only make 0.75 percentage points annually by selling or managing mutual funds."[9]

3.3 Competition in Lending

3.3.1 Wholesale Lending

In the wholesale lending market, commercial banks meet two kinds of competition: competition from nonbank finance companies that hold loan assets on their own accounts and the challenge from capital market instruments, usually arranged by securities houses. As shown on **Table 3-3**, as of year-end 1992, more than half the debt of nonfinancial corporations was raised by corporate bonds; **Table 3-4** shows that the wholesale lending assets of some large nonbank finance companies reached or exceeded those of major commercial banks in 1990. As stated earlier (section **3.1**), the combined development of

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[6]Robert McGough, "Stock Funds Had Record Inflows in December," *Wall Street Journal*, Jan. 28, 1994, C1.

[7]Penny Lunt, "How Are Mutual Funds Changing Banks?" *ABA Banking Journal*, June 1993, 31.

[8]Mary Romano, "Mutual Fund Sales Growing At Bank ATMs," *Wall Street Journal*, Aug. 16, 1993.

[9]Randall Smith, *Wall Street Journal*, June 30, 1993, C1.

Table 3-2

The Ten Banks That Made the Most Money on Mutual Fund Advisory Fees in 1992

BankAmerica Corp	$19,614,110
First of America	$18,213,000
Morgan Guaranty Trust	$16,391,743
Wells Fargo	$16,353,292
NBD Bank, NA	$15,695,566
Northern Trust Company	$12,748,714
Fleet Financial Corp	$9,928,410
Society Corporation	$9,372,110
Midlantic National Bank	$7,949,000
NationsBank Trust	$7,903,283

Source: Lipper Analytical Services, Inc., New York. Quoted in Penny Lunt, "How are mutual funds changing banks?" *ABA Banking Journal*, June 1993, 32.

Table 3-3

Credit Market Debt of Nonfinancial Corporate Business As of Year-End 1992

Credit Market Instruments	Amount ($ U.S. Billions)	Percent of Total
Corporate Bonds*	1,233	53
Mortgages	199	9
Bank Loans**	543	23
Commercial Paper	107	5
Finance Company Loans	148	6
Other Loans***	90	4
Total	2,320	100

*Includes tax-exempt debt. **Includes Savings and Loans and Bankers' Acceptances.
***Includes U.S. government and foreign loans.

Source: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts—Financial Assets and Liabilities, by Sector," *Annual Statistical Digest 1992*, 101.

capital markets instruments and nonbank finance companies puts competitive pressure on commercial banks.

Capital Market Instruments. The development of capital markets is primarily owing to advanced information technology. In almost every area—execution of dealings, transmission of securities prices, settlements of transactions, and internal risk control—computer and telecommunications networks are sustaining the evolution of capital markets.

Long-term bonds issued in large amounts are instruments used by manufacturing or utility companies to raise funds for capital investments, but they are not adequate for fulfilling short-term needs or for small-amount funding. Flexibility of amount, term, and timing was previously regarded as a feature provided only by commercial bank loans, even after long-term bonds came in as a method of corporate fund raising. The recent development in capital market instruments made it possible to offer various alternatives to issuers and investors insecurities and has eaten away at the share of commercial bank loans. By introducing commercial papers and medium-term notes, nonbank companies can issue securities in smaller amounts and choose the date of maturity more flexibly. Once they draw up a prospectus of these securities, they can use it repeatedly to issue the securities in various denominations and maturities.

Companies can raise their funds at a lower cost through capital markets than through commercial bank loans, because the funding cost of capital market instruments does not include the margin of commercial banks. Commercial banks usually gather their funds by taking deposits from those who have a fund surplus and then lending them to others with a fund shortage at the rate of deposit interest plus their margin. Capital markets directly connect the fund surplus and fund shortage and allow borrowers to cut commercial banks' margins. In a recent trend, even security houses have been by-passed for issuing and trading securities.

Public corporate bonds are underwritten by security houses and then distributed to each investor. The underwriting fee is paid by issuers. But since the 1980s some corporations issued bonds directly to insurance companies, pension funds, and other institutional investors in a system called private placement. SEC Rule 144 A, adopted in 1990, liberalized the secondary trading of privately placed securities and, as a result, increased the number investors for such securities.

Commercial papers are ordinarily issued through commercial paper dealers, and the dealer fee is included in the prices offered. Since the 1980s, some large commercial paper issuers such as General Electric Capital Corp. and General Motors Acceptance introduced direct placement systems to distribute commercial papers directly to money market mutual funds and other institutional investors.

Table 3-4

Major Holders of Domestic Commercial and Industrial Loans*

Selected Finance Companies[1]	C&I Loans
General Electric Capital	26.3
Ford Motor Company[2]	11.1
Chrysler Financial	6.7
CIT Group[3]	5.8
Heller Financial[4]	5.1

Foreign Banks[5]	C&I Loans
Bank of Tokyo	12.5
National Westminster Bank	10.1
Marine Midland/Hong Kong & Shanghai	6.8
Mitsubishi Bank	8.9
Sumitomo Bank	8.0

U.S. Bank Holding Companies	C&I Loans
Citicorp	19.8
Chase Manhattan Corporation	15.8
BankAmerica Corporation	15.6
Security Pacific Corporation	16.8
Chemical Banking Corporation	15.7

*Includes commercial and industrial loans and leases extended to U.S. borrowers.
[1]Finance company data excludes all loans and leases related to product of the parent company (e.g., GMAC is excluded because its wholesale receivables appear to be automobile related). [2]Includes non-auto-related assets of Ford Motor Credit and The Associates Corporation. [3]60 percent owned by Dai-Ichi Kangyo Bank. [4]Owned by Fuji Bank. [5]Includes loans through U.S. chartered subsidiaries, as well as branches and agencies of parent bank.

Sources: U.S. Bank Holding Company Data from Report Y-9(c). Foreign Bank Data from the Call Report Form 002 and RSSD. Estimates of finance company loans by Federal Reserve Bank of New York based on annual reports and Form 10-K. Quoted in Lawrence M. Sweet, "Competition in Wholesale Credit Services," Federal Reserve Bank of New York, A Staff Study, May 1992.

In security trading, dealing can bypass security brokers. For example, dozens of firms trade stocks by computers directly linked to the National Association of Securities Dealers Automated Quotation System (NASDAQ).[10]

Capital markets are beneficial for borrowers: the expansion of capital markets led a huge number of investors to join the market and offer competitive prices for securities. In loan markets, the number of lenders is limited, because loans have less liquidity than corporate bonds and because loan agreements are not standardized and, in comparison with a bond prospectus, are rather complicated. But in capital markets even consumers can participate as fund suppliers, and U.S. companies can have access to investors worldwide through domestic and overseas markets.[11]

The revolution in information technology has contributed to the expansion of capital markets chiefly in two ways.

The first is in assuring the liquidity of securities. Lending involves credit risks and market risks (interest-rate risks), but securities with enough liquidity can reduce these risks because investors can sell them and limit their losses if the price of the securities drops to a certain level or the securities' credit rating is downgraded. Assurance of liquidity is an important factor in attracting large institutional investors like insurance companies and pension funds. Computerized settlement systems for securities transactions and information networks that provide the prices of securities and credit information on issuers contribute considerably to maintaining the liquidity of securities.

The second is in acceleration of deregulation. Through advanced information technology, security issuers and investors are no longer limited to choices in the domestic market. They can select the most favorable market for their purposes. In this globalized capital market, if a regulator imposes any regulation or tax unfavorable to issuers or investors, the issuers and investors will only shift to other capital markets, resulting in a decline of the capital market controlled by the regulator. Competition among world capital markets and among players in that market is intensifying the trend toward deregulation.

Nonbank Finance Companies. Using low-cost funds raised through capital markets, nonbank finance companies can offer customers aggressive lending rates and thus can compete

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[10]Richard Behar, "Bypassing the Brokers," *Time*, June 7, 1993, 42.

[11]Japanese nonfinancial corporations, for example, must report the amount, term, execution date, and purpose to the Ministry of Finance before they lend money overseas, but they do not need to do so when they purchase securities listed on major world exchanges. For Japanese investments in foreign securities see Table 6-9.

with commercial banks. If they cannot gain access to capital markets[12] their fund raising would have to depend on borrowing from commercial banks, and offering lower lending rates than commercial banks would not be possible. The liabilities of nonbank finance companies are shown in **Table 3-5**.

Table 3-5

Finance Company Liabilities as of Year-End 1992

Credit Market Instruments	Amount ($ U.S. Billions)	Percentage of Total
Bank Loans	37.6	8
Due to Parent	37.8	8
Commercial Paper	156.4	32
Corporate and Foreign Bonds	180.8	37
Other Liabilities	71.2	15
Total	483.8	100

Sources: Data for Corporate and Foreign Bonds from Board of Governors of the Federal Reserve System, "Flow of Funds Accounts—Financial Assets and Liabilities, Private Nonbank Financial Institution," *Annual Statistical Digest 1992*, 97. Other data from "Domestic Finance Companies: Assets and Liabilities," 88.

One characteristic of securities issued by nonbank finance companies is that often their credit is supported by parent companies. Most major nonbank finance companies are subsidiaries of large nonfinancial corporations, and the commercial paper and long-term notes they issue can obtain high credit ratings supported by the parents. **Table 3-6** lists the credit ratings of several major nonbank finance companies and their parent companies.

Credit supports are not necessarily a formal guarantee by the parent company. Sometimes they are provided in the form of keep-well agreements, in which the parent company promises to maintain a certain amount of capital or a certain ownership ratio at its subsidiary. Even without a guarantee or keep-well agreement between the parent company and its subsidiary, credit rating agencies often rate the credit of the subsidiary as equal or close to that of its parent, appreciating the implicit support from the parent company when the relationship is judged sufficiently tight.

[12]Japanese nonbank finance companies were prohibited from issuing commercial papers in the domestic market until July 1993; see Chapter Six.

Table 3-6

Credit Ratings on Debt Securities Issued by Major Finance Companies and Parent Companies as of December 1993

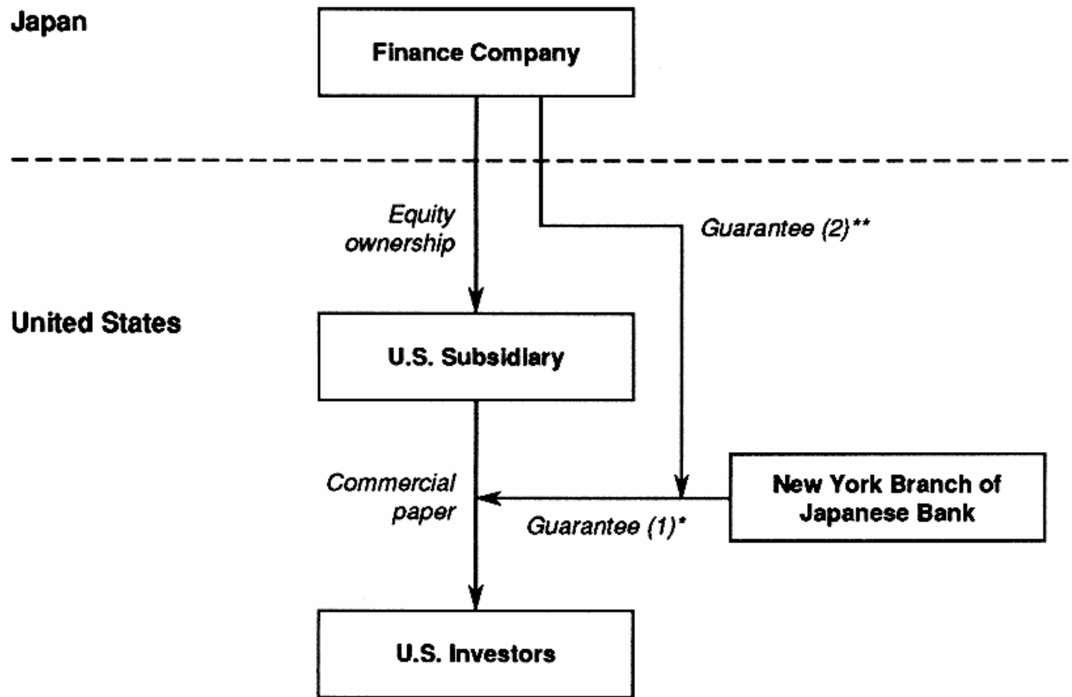
Finance Company/ParentCompany	Ratings by Moody's
General Electric Capital Corp.	Aaa
General Electric Co.	Aaa
AT&T Credit Corp.	Aa3
American Telephone and Telegraph	Aa3
Ford Motor Credit Co.	A2
Ford Motor Co.	A2
IBM Credit Corp.	A3
IBM Corp.	A3
General Motors Acceptance	Baa1
General Motors Corp.	Baa1
Chrysler Financial Corp.	Baa2
Chrysler Corp.	Baa2

Note: Moody's Investors Service rates corporate long-term debt by 20 ranks: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C, and D, according to the quality of credit.

Source: Moody's Investors Service, "Moody's Bond Survey," December 27, 1993.

It is difficult for each investor to explore either the legal effectiveness of a keep-well agreement or the relationship between a parent company and its financial subsidiary, but credit ratings standardize information for the level of credit support given by parents so investors can judge the credit risk on that basis.

U.S. commercial banks face competition not only with domestic banks and nonbank financial institutions but also with foreign banks and nonbank firms. **Figure 3-2** illustrates the transaction involved when a subsidiary of a Japanese nonbank finance company issues commercial papers in the U.S. capital market that are guaranteed by a Japanese commercial bank. If the company has a high credit rating, the subsidiary can issue commercial papers carrying its guarantee and the transaction will be simple. Owing to the liberalized U.S. capital market system, Japanese nonbank finance companies were able to issue commercial papers in the U.S. market through subsidiaries before July 1993, when they were permitted to issue them in the Japanese capital market. In this way, even highly regulated sectors in foreign countries can enter the U.S. market as competitors. (See **Chapter Six** for a discussion of competition in the Japanese market under Japanese regulations.)



*New York branch of Japanese bank guarantees the payment commercial paper issued by U.S. subsidiary.
**Finance company compensates the Japanese bank for loss arising at the New York branch, according to Guarantee (1).

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Figure 3-2

Issuance of Commercial Paper by Subsidiary of Japanese Finance Company

Consideration of Credit Risk. In the competition of fund gathering, credit risk is not usually a problem of financial institutions, because the risk is assumed by the institution's depositors. The institution with the most deposits is usually the most profitable, unless the interest rates it pays are too high.

In retail lending, so long as its assets are sufficiently diversified, a financial institution is rarely seriously damaged by loan deterioration, because the amount of credit loss in retail lending can be estimated statistically and added to the interest rate margin.

In the wholesale lending market, however, credit risk is a very important aspect. Profit from wholesale lending business depends on the quality of the lending assets rather than their amount. In this competitive market, obtaining enough margin to cover credit loss in the future is difficult for all financial institutions. Defaults on only a small portion of a loan may ruin profits gained from other loans.

Unlike its effect on retail lending, information technology has not been so useful for credit analysis in wholesale lending, an area that relies more on human judgment. Commercial banks have suffered from largely deteriorating assets, especially in the 1980s in lending to less developed countries (LDCs) and in commercial real estate and highly leveraged transactions, most executed in the 1980s.

A decrease in the share of commercial banks in the wholesale lending market spreads credit risk to nonbank financial institutions, nonfinancial corporations, and individuals.

Like commercial banks, life insurance companies that aggressively participated in the 1980s in loans secured by commercial real estate since then have been faced with an increase of bad loans. "No industrywide figures exist for how much of the foreclosed property has been sold. The fifteen largest insurers sold $1.95 billion of properties last year, most of them acquired through foreclosure, according to Townsend & Schupp, a Hartford-based insurance consultant. Those same insurers have another $7.8 billion of foreclosed property left."[13]

Although the development of the junk bond market allowed less creditworthy corporations access to capital markets, the increase in defaults since late 1980s incurred large losses for investors of those bonds. **Table 3-7** shows the amounts of corporate bond default in 1981–91.

From the standpoint of borrowers, competition among lenders gives them the opportunity to raise funds at a lower cost. The expansion of capital markets and the entry of nonbank finance companies into the lending market have significantly benefited corporations that need funding. But such competition is not offered to all corporations. The level of competition depends primarily on the credit standing of borrowers.

Credit ratings have played an important role in inviting investors, including those who do not specialize in credit analysis, by providing standardized information on the quality of the issuer's credit. Companies with high ratings enjoy access to a wide range of investors and can raise funds at low cost. Companies rated below investment grade ratings (i.e., less than triple-B), cannot always borrow through capital markets at lower rates than from commercial banks. The number of investors in the junk bond market is smaller than in the investment grade securities market, and the capacity of the junk bond market fluctuates depending on the economy and on the attitude of investors. Having experienced the recession in the United States in 1990–91, commercial banks now have stricter credit policies. Insurance companies are no longer aggressive in commercial real estate loans and junk bond investments. With the growth of capital markets, even medium-size and small companies can issue securities in the

[13]Greg Steinmetz and Mitchell Pacelle, "Many Insurers Bet on Riding Out the Real-Estate Slump," *Wall Street Journal*, July 9, 1993.

market, but these companies may have difficulty in borrowing when most financial institutions and bond investors are very nervous about the credit quality of borrowers.

Table 3-7

Default of Corporate Bonds Rated by Standard & Poor's

	Number	Amount ($ U.S. Millions)
1981	2	60
1982	19	843
1983	10	417
1984	14	648
1985	16	1,176
1986	35	3,263
1987	20	9,056
1988	31	4,439
1989	39	5,965
1990	66	15,094
1991	88*	25,524*

*Includes debt restructuring.

Source: Standard & Poor's Corp., "Credit Rating and Default," Materials distributed at the Seminar in Tokyo, November 26, 1993.

Credit rating agencies are not government but private companies. They receive fees from both bond issuers and subscribers to information on credit ratings. Most issuers want to obtain credit ratings because with them they can sell bonds at higher prices, but in the United States no regulation obliges issuers to get credit ratings. Many investors subscribe to information from credit rating agencies and pay the fees, because they believe the information is useful in seeking a higher return on investments; the agencies are not responsible for the investors' losses even if caused by the credit analysis. Major agencies such as Standard & Poor's and Moody's established their reputations through accurate credit evaluations, but they, too, are in competition with other agencies.

3.3.2 Retail Lending

Until the late 1970s the retail lending business was segmented by the type of financial institution. S&L associations provided funds for purchasing houses, credit unions financed regional capital needs, and other specialized finance companies provided retail credit such as auto loans.

As in wholesale lending and fund gathering, throughout the 1980s deregulation and the advancement of information technology brought new competition and new entries into the retail lending market. By the DIDMCA of 1980, S&L associations were allowed to engage in the consumer loan and credit card businesses. A large number of nonbank finance companies began to provide retail lending services such as credit card loans.

Nonbank Finance Companies. The transition of commercial banks' and finance companies' shares of the retail lending market since the late 1980s reveals a trend different from that of wholesale lending and fund gathering, where commercial banks have been continuously losing their share. As shown in **Table 3-8**, since 1986 commercial banks have recovered their share of consumer installment credit market. In the area of residential mortgage loans, the shares of insurance companies and nonbank finance companies remain small (see **Table 3-9**), perhaps due to economies of scale, which may benefit long established players like commercial banks.

Economies of scale can be seen especially in two areas, (*i*) credit risk control and (*ii*) transaction processing.

(*i*) "By applying statistical techniques, large firms can measure and manage the default and cash flow risk in retail products such as mortgages, consumer loans, and credit card loans. Institutions that invest in the computer facilities and training needed to statistically monitor credit risk appear to be able to originate, price, and manage the credit risk of consumer lending products more efficiently than many competitors...."[14] On the contrary, a new entrant will confront greater risks by the lack of such database.

(*ii*) Advanced computer technology is indispensable for processing a large number of transactions. "Banks' experience in servicing retail deposits may have given them a better appreciation of the new technology, so that they were quicker than finance companies to offer card-based revolving credit. The technology allowed the extension of credit to be linked to

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[14] Paula R. Worthington, "Retail Banking: A Recent History and an International Comparison," A Staff Study, Federal Reserve Bank of New York, May 1992, 146.

purchases of a wide range of goods and services, an arrangement customers evidently found more convenient than the traditional personal loans from finance companies."[15]

Table 3-8

Consumer Installment Credit as of Year-End

Year	Commercial Banks ($ U.S. Billions)	Finance Companies ($ U.S. Billions)	Share of Finance Companies*
1992	332	117	26%
1991	340	122	26%
1990	347	137	29%
1989	344	141	29%
1988	325	146	31%
1987	287	141	33%
1986	267	135	34%
1985	245	112	31%
1984	212	90	30%
1983	172	83	33%
1982	152	75	33%
1981	148	70	32%
1980	147	62	30%

*Finance company share of total consumer installment credit extended by commercial banks and finance companies.

Sources: Board of Governors of the Federal Reserve System, "Installment Credit: Total Outstanding," *Federal Reserve Bulletin*, December 1991, A37, and *Annual Statistical Digest 1980-89*, 242-246, 1991, 92, and 1992, 92.

[15]Eli M. Remonola and Kurt C. Wulfekuhler, "Finance Companies, Bank Competition, and Niche Markets," *Federal Reserve Bank of New York, Quarterly Review* (Summer 1992), 32.

Table 3-9

Mortgage Debt Outstanding, 1- to 4- Family

As of Year-End, in $ U.S. Billions

Type of holder	1980	1985	1991
Commercial Banks	160	213	485
Savings Institutions	487	554	534
Life Insurance Companies	18	12	12
Finance Companies*	14	29	52
Federal and Related Agencies**	61	110	164
Mortgage Pools or Trusts***	122	383	1,134
Others	103	200	523
Total	965	1,501	2,904

As of Year-End, Percentage of Total

Type of holder	1980	1985	1991
Commercial Banks	16.6	14.2	16.7
Savings Institutions	50.5	36.9	18.4
Life Insurance Companies	1.9	0.8	0.4
Finance Companies*	1.5	1.9	1.8
Federal and Related Agencies**	6.3	7.3	5.6
Mortgage Pools or Trusts***	12.6	25.5	39.0
Others	10.7	13.3	18.0
Total	100.0	100.0	100.0

*All mortgage debt outstanding held by finance companies is assumed to be 1- to 4- family type. **Includes Government National Mortgage Association, Farmers Home Administration, Federal Housing Administration and Veterans Administration, Federal National Mortgage Association, Farm Credit Banks, and Federal Home Loan Mortgage Corporation. ***Does not include private pools.

Source: Board of Governors of the Federal Reserve System, "Mortgage Debt Outstanding, by Type of Holder and Type of Property," *Annual Statistical Digest 1980-89*, 237-239 and 1991, 91.

Although economies of scale exist in some areas of retail lending, a number of nonbank financial institutions as well as commercial banks have been successful in this market, because many of them could establish computer systems to control credit risks and process huge numbers of transactions. Other large firms capable of establishing advanced computer systems and that have distribution channels to customers have entered the retail lending market.

Table 3-10

Top Twenty-Five Companies in Bank Credit Card Loans, 1991 ($U.S. Millions)

Company	Total Credit Card Portfolio ($ U.S.Millions)
1. Citicorp	37,950
2. Chase Manhattan	12,977
3. Sears, Roebuck*	11,326
4. MBNA Corp	9,164
5. BankAmerica	8,891
6. American Express*	7,626
7. First Chicago	7,544
8. Norwest	7,067
9. Chemical Banking	6,001
10. Banc One	5,881
11. Nations Bank	5,071
12. Bank of New York	4,335
13. AT&T*	3,800
14. Wells Fargo	3,710
15. General Electric*	3,240
16. Household International*	3,038
17. Capital Holding Corp*	2,972
18. Security Pacific	2,309
19. First USA Inc.*	2,122
20. First Interstate Bancorp	2,080
21. USAA*	2,052
22. Wachovia Corp	1,973
23. ADVANTA Corp*	1,876
24. First Bank System	1,824
25. Signet Banking	1,749

*Nonbanks.

Source: American Banker. Quoted in Standard & Poor's Corp., "Banking and Other Financial Services Basic Analysis," *Standard & Poor's Industry Surveys*, November 12, 1992, 32.

Consumer credit bureaus, such as TRW, Equifax, and Trans Union, let new entrants have access to consumer credit data purchased from established players, including commercial banks and retailers. For example, Merrill Lynch not only offers secured loans such as home mortgages, home equity loans and mortgage refinancing, but also encourages cash-management and brokerage-account investors to borrow, for any purpose, against the

borrowers' assets at the firm.[16] Sears Roebuck, AT&T, General Motors, General Electric, and other nonfinancial companies joined the credit card business, using databases and distribution channels obtained through their original businesses. **Table 3-10** shows that nine of the top twenty-five companies offering credit card loans were nonbank companies.

Nonbank finance companies are also active in some special markets such as auto loans, where subsidiaries of automobile manufacturers have extra advantages, and in the operating lease market, which commercial banks had been prohibited from providing until the end of 1980s.

Asset-Backed Securities. Although introducing bonds and commercial papers into the wholesale lending business was easy, it was difficult to introduce them into the retail lending business, because the retail loans' denominations are usually small and odd, the cash-flow is unique and unpredictable, and the quality of credit is low and costly to evaluate.

Recent developments in computer technology, however, have made it possible to transform retail loans, including residential mortgages, automobile loans, and credit card loans, into marketable securities, called asset-backed securities (ABSs).

George G. Kaufman explained the process of transformation (see **Figure 3-3**) as follows:

> In securitization, a financial entity, such as a commercial bank, investment bank, or similar institution, puts together a pool or package of less marketable, small whole securities. These are generally transferred to a third party that serves as a trustee. New securities are created that are collateralized by the existing pooled securities, but are more highly marketable by designing large standard denomination, more predictable cashflows and higher credit quality. The payments on the old securities are passed through to the new securities. Credit quality is enhanced because pooling reduces risk through diversification. In addition, for some securities, insurance may be purchased by the issuer to guarantee the timely payments of coupons and principal. The issuer retains responsibility for servicing the original loans. so that the pure financing part of the loan is spun off and sold separately, but generally does not assume the risk of default.[17]

This method has been used by both commercial banks and nonbank finance companies to increase liquidity and diversify their asset portfolios. Through securitization, financial intermediaries, including commercial banks and nonbank finance companies, can be released

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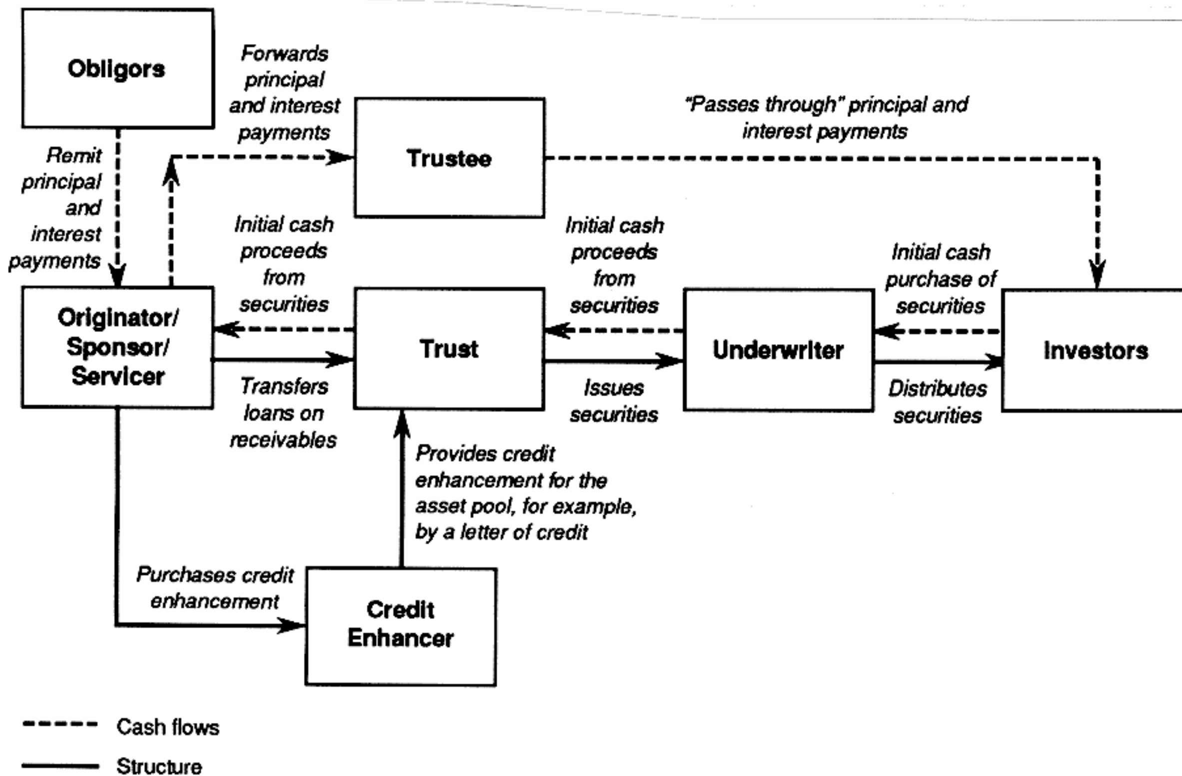
[16]Michael Siconolfi, "Merrill Lynch, Pushing into Many New Lines, Expands Bank Services," *Wall Street Journal*, July 7, 1993, A1.

[17]George G. Kaufman, *The U.S. Financial System: Money Markets, and Institutions* (Englewood Cliffs, N.J.: Prentice Hall, Inc., 1992), 434.



Source: Thomas R. Boemio and Gerald A. Edwards, Jr., "Asset Securitization: A Supervisory Perspective," *Federal Reserve Bulletin* (October 1989), 661.

Figure 3-3

Pass-Through Asset-Backed Securities and Cash Flow

from the default risk of retail loans. The intermediaries receive only servicing fees, and the rest of the payment from original loans is transferred to various investors, including nonfinancial corporations and individuals. Asset-backed securities support the trend toward disintermediation in financial services. As **Table 3-9** shows, at the end of 1991, residential mortgage-backed securities, the most popular type of asset-backed securities, were the largest fund provider in the residential mortgage debt market.

Chapter Four

Reform of the Commercial Banking Industry

As described in **Chapter Three**, new entries into fund gathering, wholesale lending, and retail lending have made traditional commercial banking businesses less profitable. At the same time, since the late 1980s competition within the commercial banking industry has been affected by the deterioration in lending assets, deregulation of securities and other nonbanking businesses, and progress in automation. In this environment, commercial banks need to decide where to focus their energies. What is the trend of mergers and acquisitions, and how profitable are large and small banks? What should commercial banks do to improve profitability? The recent decline and recovery of income in the commercial banking industry, the trend toward the diversification of revenue, increased mergers and acquisitions, and factors that have influenced these phenomena are examined in this chapter through an analysis of statistics on the composition and levels of revenue, income, and assets.

4.1 The Decline of Income Since 1987 and Recovery Since 1992

As **Table 4-1** shows, the net interest margin of commercial banks remained stable during 1985-91 in spite of increasing competition of commercial banks with other financial institutions. The commercial banking industry experienced a serious decline in net earnings in 1987, and relatively low returns on equity continued during 1989-91, in spite of a brief recovery in 1988 (**Table 4-2**). The number of failed banks reached 208 in 1988 and 206 in 1989 (**Table 4-3**). **Table 4-2** shows that an increase in loan loss provision caused by the deterioration of assets damaged the banks' net income in 1987, 1989, 1990, and 1991, although actual net interest income increased throughout.

> The departure of higher quality corporate borrowers to the capital markets in the past 25 years brought the money center institutions to a strategic crossroads. Two companies, Morgan and Bankers Trust, opted to compete increasingly as securities firms, in effect following their corporate clientele to the capital markets. The others, while developing securities and derivatives capabilities, continued to emphasize loan origination and, to a large degree portfolio lending [that is, holding loans on own accounts]. For all of the money centers, the result has been a succession of high-risk loan concentrations, first in LDC lending, then in HLT [highly leveraged transactions], and most recently in commercial real estate....[1]

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[1]Debra J. Perry, May Lee, and Christopher T. Mahoney, "U.S. Money Center Banks," Moody's Industry Outlook, February 1993, 9.

These high-risk loans brought high margins for commercial banks, but afterward, suppressed their profits tremendously because of large losses on these loans.

Table 4-1

Net Interest Margin for All Insured Commercial Banks (In Percent)

Year	Net Interest Margin (in Percent)
1992	3.90
1991	3.61
1990	3.46
1989	3.53
1988	3.54
1987	3.44
1986	3.47
1985	3.57

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 665.

4.1.1 LDC Lending

According to Moody's, "Money center [commercial banks] LDC outstanding at mid '92 declined nearly 50% to $16.6 billion compared with mid '91, continuing a downward trend since the late 1980s. Part of this reduction was due to the removal of Mexico from the list of creditor countries, as well as to loan sales and swaps and write-offs."[2] "The generally improved creditworthiness of Latin American borrowers has permitted the money centers to reallocate substantial portions of LDC reserves to general reserves."[3] The debt crisis in the LDCs might no longer be a serious problem for U.S. commercial banks, but the damage it caused in the late 1980s should be noted.

When oil prices first rose enormously in 1973-74, large commercial banks took deposits from oil exporters and looked for borrowers in order to recycle the oil money profitably.

[2] Ibid., 19.

[3] Ibid.

Table 4-2

Income Data for All Insured Banks
($U.S. Millions)

	1983	1984	1985	1986	1987
(1) Net Interest Income	72,840	78,304	90,708	94,797	99,789
(2) Loan Loss Provisions	10,614	13,704	17,829	22,206	37,712
(3) Noninterest Income	23,205	28,617	31,266	36,125	41,862
(4) Noninterest Expense	66,397	73,247	82,469	90,457	97,643
(5) Securities Gains	–30	–146	1,552	3,934	1,444
(6) Income before Taxes	18,995	19,824	23,227	22,195	7,739
(7) Net Income	14,989	15,379	17,835	17,213	2,530
(8) Return on Equity (percent)	11.24%	10.59%	11.07%	9.84%	1.40%

	1988	1989	1990	1991	1992
(1) Net Interest Income	107,339	111,829	115,321	121,681	133,930
(2) Loan Loss Provisions	17,052	31,071	31,965	34,248	26,556
(3) Noninterest Income	45,643	51,670	55,761	60,852	67,010
(4) Noninterest Expense	102,202	108,539	116,201	125,871	132,612
(5) Securities Gains	275	793	470	2,897	3,951
(6) Income before Taxes	33,553	24,682	23,386	25,311	45,722
(7) Net Income	24,351	15,377	16,194	17,719	31,630
(8) Return on Equity (percent)	12.98%	7.59%	7.57%	7.86%	12.80%

Note: (6)=(1)-(2)+(3)-(4)+(5). Nondeposit trust companies are included for 1985–1993.

Sources: Data for 1983–1984 are from Mary M. McLaughlin and Martin H. Wolfson, "The Profitability of Insured Commercial Banks in 1987," *Federal Reserve Bulletin*, July 1988, 405, 413. Data for 1985–92 are from Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 663, 665.

Table 4-3

Number of Failed Commercial Banks

1982	6
1983	7
1984	78
1985	118
1986	141
1987	183
1988	208
1989	206
1990	159
1991	105
1992	98

Source: Federal Deposit Insurance Corporation, Division of Research and Statistics, "Changes in Number of Insured Commercial Banks and Trust Companies," *Historical Statistics on Banking 1934-1992*, 6.

Because those high oil prices depressed the economies of industrialized countries, the demand for loans could not grow. For developing countries, this situation proved an opportunity to borrow money at very low cost and invest it in domestic capital at a time when a money surplus was sufficient to push down interest rates. "Under these circumstances, willing lenders found willing borrowers, and the external debts of the developing countries increased from less than $100 billion in 1972 to more than $600 billion by 1981. That sixfold increase, mainly in the form of syndicated commercial-bank loans, now looks reckless, especially since everybody knows what happened next. But it is worth remembering that, at the time, few thought it outlandish."[4]

In the 1980s, as the dollar interest rate jumped and the prices of commodities exported by less developing countries dropped, the LDCs faced a serious debt crisis. All Latin American countries, except Colombia, one after another asked for a rescheduling of debts owed to foreign governments and commercial banks. In 1987 Citicorp reserved $3 billion to cover the loss on these loans, and in 1989 the combined net income of nine U.S. money center banks plunged to a deficit of $2,830 million, mainly because of additional reserves for

[4]Clive Crook, "Third-World Finance," *The Economist*, Sept. 25, 1993, 8.

the losses on LDC loans.[5] "This was not the first time that economic euphoria soon turned to bitter disappointment, and it is safe to predict that it will not be the last."[6]

The amount a commercial bank will lend to a government of an LDC tends to be larger than loaned to a private company. Therefore, once a debt is rescheduled, the loss for the commercial bank will be enormous. To avoid such a loss, commercial banks and many other institutions vigilantly watch the credit conditions of the LDCs, and organizations such as rating agencies and the Institute of International Finance also monitor the credit risks and provide information to commercial banks and other creditors of those countries. The rapid development of telecommunications and mass communications have significantly improved the information flow—but could anyone in the early to mid-1970s have reasonably predicted the debt rescheduling of Latin American countries?

The share of commercial bank loans in outstanding long-term debt of middle-income countries dropped from 57 percent in 1985 to 33 percent in 1991, because commercial banks have been reluctant to lend to developing countries since the debt crisis in Latin America and because these countries have expanded fund raising from capital markets (**Table 4-4**). Borrowing from commercial banks may remain an essential source of funds, especially for low-income LDCs that do not have ready access to bond markets and must rely on official credit (**Table 4-5**). Lending to LDCs is a difficult business, but one regarded as a mission of commercial banks. Loans from commercial banks in industrialized countries have helped many countries in the early stages of development. Although massive loans such as were extended to Latin American countries in the 1970s can injure the healthy development of those countries, adequate lending to developing countries can contribute towards their prosperity. The reduction in loans to LDCs improved the quality of assets of commercial banks in the United States, but at the same time it may mean a decline in the importance of their roles in the development of the world economy.

4.1.2 Highly Leveraged Transactions Lending

During the boom in mergers and acquisitions in the mid- to late 1980s, commercial banks expanded financing for leveraged buy-outs (LBOs) and corporate restructuring, as the interest margins on such loans are usually higher than those on normal commercial loans.

Computer software developed for commercial banks, investment banks, and nonfinancial corporations that wish to acquire other corporations was used to project the cash flow of

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[5]Salomon Brothers, United States Equity Research, Commercial Banks, Bank Annual: 1993 Edition, 40. The nine money center banks include Bank of New York, Bankers Trust NY, Chase Manhattan, Chemical Banking Corp, Citicorp, J.P. Morgan & Co., Republic NY Corp., First Chicago, and Continental Bank Corp.

[6]Crook, "Third World Finance," 5.

Table 4-4

Long-Term Debt of Middle-Income Countries (\$U.S. Millions)

	1970	1980	1985	1991
Official Creditors	14,679	81,856	165,876	310,608
Commercial Banks	18,380	180,307	348,648	258,757
Bonds	1,577	12,069	28,374	114,296
Other Private Creditors	5,959	42,382	63,434	92,786
Total	25,915	234,757	440,456	465,839
Share of Commercial Banks (percentage)	45%	57%	57%	33%

Note: Middle-income countries are those in which the 1991 GNP per capita income was more than \$635 and less than \$7,910.

Source: World Bank, *World Debt Tables* 1992-93, Tables 212.

Table 4-5

Long-Term Debt of Low-Income Countries (\$U.S. Millions)

	1970	1980	1985	1991
Official Creditors	17,669	77,685	138,954	268,473
Commercial Banks	1,054	16,952	26,654	55,906
Bonds	348	1,011	3,169	11,919
Other Private Creditors	2,051	14,579	34,178	47,110
Total	21,121	110,228	202,955	383,409
Share of Commercial Banks (percentage)	5%	15%	13%	15%

Note: Low-income countries are those in which the 1991 GNP per capita income was no more than \$635.

Source: World Bank, *World Debt Tables* 1992-93, 208.

income and debt repayment. By replacing some of the assumptions, such as growth rates of total revenue and operating expenses, the software could provide simulations that ranged from optimistic to pessimistic scenarios. Computerized projections formed the chief basis for targeting acquisitions and estimating amounts of debt. During the boom, most people in the commercial banking industry believed that income and debt repayment would prove as the computers forecast, or at least do better than the pessimistic scenarios. Financing for takeovers or restructuring in those years was believed to be a new source of income for commercial banks developed by advanced technology in finance and computers.

Borrowers in such transactions, however, had large debt but relatively little capital, and the credit risk involved in such lending was therefore high. With the weakening of the U.S. economy in the recession of 1990–91, defaults on these loans increased. Higher capital requirements implemented by the Bank for International Settlements (BIS) and criticism by federal regulators of highly leveraged transactions (HLT) lending deterred commercial banks from such lending and increased the difficulty for highly leveraged companies of refinancing debt.

According to Standard & Poor's, the outstanding HLT loans of fourteen major U.S. commercial banks fell about 24 percent in 1991, as new loan opportunities became scarce, regulators deleted some types of companies (e.g., inherently highly leveraged telecommunications companies) from the definition of "highly leveraged companies," and older loans were repaid. The nonperforming assets in those portfolios rose dramatically to 11.9 percent in 1991, up from 8.2 percent in 1990 and 3.4 percent in 1989 (**Table 4-6**).[7]

One of the regulatory issues in HLT lending is classification. In 1989, the FDIC defined HLT lending as "a transaction in which credit is extended in connection with LBOs, mergers and acquisitions, or corporate restructuring, and where the credit results in an organization that has a total debt/asset ratio exceeding 75%;"[8] FDIC examiners were encouraged to use the amount of HLT loans and its ratio to total loans as a benchmark to assess the asset quality of commercial banks. This guideline was a response to increasing concern in the Congress and among taxpayers about the deterioration of the asset quality of commercial banks. Requests to report amounts of HLT lending were blamed by some commercial banks and nonfinancial borrowers for causing credit crunches in industries that traditionally have a highly leveraged capital structure, such as cable television companies, and for disturbing the recovery of economy.

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[7]Standard & Poor's Corp., "Banking and Other Financial Services Basic Analysis," Standard & Poor's Industry Surveys, Nov. 12, 1992, 27.

[8]Glenn G. Munn, F.L. Garcia, and Charles J. Woelfel, "Encyclopedia of Banking & Finance," Bankers Publishing Company and Probus Publishing Company, 486.

Table 4-6

Exposure of Major Banks to HLT Loans

	Outstanding HLT loans ($ U.S. Billions)		Non-Performing HLTs as a % of all HLT Loans	
	1990	1991	1990	1991
Chemical Bank	6.00	5.50	9.0	13.4
Citicorp	7.20	4.90	17.8	28.8
Security Pacific	4.40	3.30	4.0	11.9
Bank of NY	4.49	3.24	7.7	5.4
NationsBank	4.50	3.20	2.2	5.7
Chase Manhattan	4.40	3.19	3.6	6.3
First Chicago	3.20	2.67	4.2	3.7
Bank of Boston	3.14	2.62	6.6	5.9
Wells Fargo	3.58	2.34	9.4	9.9
Bankers Trust	3.00	2.30	16.7	24.3
BankAmerica	2.18	1.78	6.4	19.2
PNC Financial	2.26	1.67	10.6	4.9
Mellon Bank	1.66	1.41	1.8	2.1
J.P. Morgan	1.90	1.30	5.3	7.7

Source: Company reports. Quoted in Standard & Poor's Corp, "Banking and Other Financial Services Basic Analysis," *Standard & Poor's Industry Surveys*, November 12, 1992, 28.

Like lending to LDCs, excessive lending for mergers and acquisitions promotes risky transactions such as LBOs that can destroy profits for both lenders and borrowers. However, restrictions on all financing for less capitalized nonfinancial companies may hinder industrial development. Success and expansion in lending by commercial banks contribute not only to their profits but also to the growth of the national economy. The question of who should watch the asset quality of commercial banks, the regulators or the banks themselves, remains an issue to be discussed by the Congress, banking regulators, and the commercial banking industry.

4.1.3 Commercial Real Estate Lending

In the 1990s, Commercial real estate (CRE) lending seems the most serious problem in the asset quality of commercial banks. In 1980, commercial and industrial loans comprised a 36 percent share of all commercial bank loans, real estate 29 percent, and individual 20 percent. Through the boom in commercial real estate development in the mid- to late 1980s, real estate loans expanded that share substantially, in 1987 exceeding commercial and industrial loans. At the end of 1992, the share of real estate loans accounted for 42 percent of all commercial bank loans (**Table 4-7**).

Table 4-7

Loan Trends, for All Commercial Banks
(Outstanding at Year-End, in $U.S. Billions)

Year	Commercial & Industrial	Real Estate	Individual	All Other	Total
1992	598	892	356	259	2,105
1991	618	873	364	242	2,096
1990	648	837	379	230	2,094
1989	642	761	376	233	2,012
1988	607	672	355	235	1,868
1987	568	587	328	228	1,711
1986	538	494	315	243	1,591
1985	501	426	295	239	1,460
1980	326	263	179	146	914

Source: Board of Governors of the Federal Reserve System, "Loans and Securities of All Commercial Banks," *Annual Statistical Digest, 1980-89*, 77-80, 1991, 23, and 1992, 23, and *Federal Reserve Bulletin*, December 1991, A16.

Because massive lending by commercial banks accelerated the boom in commercial real estate construction and brought an oversupply of buildings, the vacancy rates of U.S. commercial real estate jumped (**Table 4-8**). For many buildings, debt payment has become impossible because the lease income has decreased. According to the Salomon Brother's survey of nine money center banks (see note 34) and twenty-six regional banks, by the end of 1992 the total of nonperforming CRE loans and foreclosed properties accounted for 31 percent of all CRE loans at money center banks and 13 percent at regional banks.

Table 4-8

Downtown Office Vacancy Rates
(In Percentages)

	1983	1991	1992
Boston	1.9	17.7	15.4
Chicago	11.3	15.8	19.6
Houston	14.6	17.6	19.1
Los Angeles	12.3	19.2	20.2
Miami	15.5	25.7	24.9
NY downtown	3.7	20.3	21.9
NY midtown	7.2	14.9	14.0
San Francisco	5.9	10.8	12.5

Source: Coldwell Banker & Co. Quoted in Salomon Brothers, "Downtown Office Vacancy Rates, 1983–Dec. 92," *Bank Annual: 1993 Edition*, 96.

Computer software developed for financial institutions, real estate developers, and appraisers was used in CRE lending in the 1980s to appraise real estate and to project future cash flow. Because vacancy rates and lease income per square foot were known to be important factors for determining cash flow, simulations included changes in them. As in HLT lending, systematic computer outputs convinced most people in the commercial banking industry that projects would go beyond at least the most pessimistic scenarios and that they should put their money on the projects.

In the financial industry, information technology has been generally useful for managing a large number of relatively small transactions. It has substantially contributed to credit risk control and transaction processing in retail lending (see section 3.3.2). New financial products such as mutual funds and ABSs were developed with computer technology that helps manage diversified assets and the distribution of income to a large number of investors.

For lending in large lots as in HLT and CRE lending, information technology has not worked well. Instead, overreliance on computer software accelerated the flow of massive funds into these risky lending areas, causing large losses at commercial banks. Spending a large amount on constructing vacant office buildings did not benefit the national economy. As illustrated by the computer trading on Black Monday in 1987, computer-instructed

transactions sometimes send large amounts of funds in one direction, harming the financial institutions or the economy as a whole.

To deter commercial banks from risky CRE lending, according to one argument, tighter regulations are necessary. The Garn–St. Germain Act of 1982 eliminated some restrictions on real estate lending. It allowed commercial banks to make loans on undeveloped land or construction where developers have very small equity. Although some people argue that this Act brought about recent disasters in the commercial real estate market, others insist that asset quality should be maintained by the self-regulation of commercial banks, because it is more effective and would avoid the cost of increased federal regulation.

4.1.4 Recovery Since 1992

The following excerpts comment on the remarkable improvement in profits at most commercial banks since 1992:

> Strong margins, improving credit quality, cost containment efforts, merger speculation, and high stock prices—can it get better than this? The answer is yes. What the industry needs now is some sign that the top line—revenues—will grow. For most in the banking industry, however, limited demand for loans will mean limited earnings gains in the near future.[9]
>
> The banks have not turned around their fundamental long-term problem—their increasing irrelevance to American companies and consumers. Almost all the earnings gains come from cutting costs and putting less money aside to cover bad loans, not from building the business...you can't reduce the set-aside for bad loans year after year. It's a one-time shot to earnings. The same is true of cost cutting.[10]
>
> The Federal Reserve, which began curing the banking industry's immediate ills two years ago with low interest rates, now is worrying about the patient's long-term health.[11]

The net income of U.S. commercial banks has shown a strong recovery since 1992. For the year ending December 1992, the combined net income of all insured commercial banks increased 79 percent from the previous year, and the return on equity grew from 7.86 percent in 1991 to 12.80 percent in 1992 (**Table 4-2**). This trend continued into 1993. The impetus

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[9] "Banking and Other Financial Services Basic Analysis," 15.

[10] Marc Levinson, "Lenders Out on a Limb," *Newsweek*, June 7, 1993, 40.

[11] Kenneth H. Bacon, "Banks' Declining Role in Economy Worries Fed, May Hurt Firms," *Wall Street Journal*, July 9, 1993, A1.

for this recovery is considered to be the increase in the interest rate margin owing to the decline in short-term interest rates, the improvement in asset quality, and the reduction in operating cost.

Most experts in commercial banking doubt this is a long-term trend. The decline of income in 1987-91 was caused by deterioration in asset quality, but an improvement in the same area cannot solve all the problems caused by their declining share in traditional banking business. The short-term income decline from the increase of credit loss provision may only have veiled a long-term trend toward an income decline caused by a fall of shares in lending and deposit taking. In the competitive environment of the 1990s, obtaining a high interest rate margin from high-quality borrowers is nearly impossible. Commercial banks will continue to experience difficulty in improving asset quality and increasing profit, and their declining share in the financial industry may more seriously affect their income in the future than the deterioration in lending assets.

4.2 Diversification of Income Sources

As commercial banks lost significant portions of their traditional businesses—deposit taking and lending—and as their profits were severely damaged by high-risk lending, they began to develop new business areas to establish other income sources. According to Edward E. Furash, managing partner of the consulting firm Furash & Co., in Washington, D.C., "the three income streams of the 1990s will be financial intermediation (deposit taking and lending), capital markets (underwriting and trading of securities for own accounts), and fee and specialty businesses.... [T]hree particular areas of specialty provide the greatest opportunities for banks to generate fee income: mortgage banking (mainly servicing), asset management, and investment sales."[12]

In 1992, commissions fees and other income accounted for 33.3 percent of gross revenues at all insured commercial banks; in 1983 the figure was only 24.2 percent (**Table 4-9**). By 1992 J.P. Morgan and Bankers Trust, two major money center banks, had shifted their main business to fee business and securities trading for their own accounts rather than traditional lending business. Later that year First Chicago Corporation followed them (**Table 4-10**).

Some commercial banking analysts think that the income from such new banking businesses cannot replace that from traditional banking business beyond current levels. According to David Cates, chairman of the bank data publishing firm Ferguson & Co., in Washington, D.C., "Unfortunately I don't think the profitability of cadging a commission on

[12]"To Find Earnings, Don't Look in the Familiar Places," *ABA Banking Journal*, March 1993, 7.

Table 4-9

Source of Revenues
(Percentage of Gross Revenues—All Insured Banks)

Year	Net Interest Income on Loans	Net Interest Income on Investments	Commissions, Fees, & Other Income
1992	48.3	18.3	33.3
1991	49.3	17.4	33.3
1990	50.2	17.2	32.6
1989	51.3	17.1	31.6
1988	51.9	18.2	29.8
1987	51.9	18.5	29.6
1986	3.5	18.9	27.6
1985	55.1	19.3	25.6
1984	53.2	20.1	26.8
1983	53.8	22.0	24.2

Source: Data for 1983–84 from Mary M. McLaughlin and Martin H. Wolfson, "The Profitability of Insured Commercial Banks in 1987," *Federal Reserve Bulletin*, July 1988, 413. Data for 1985–92 from Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 663.

a mutual fund or annuity sale is as good as the profitability of taking a spread on a loan."[13] William H. Dougherty, group executive vice president and chief financial officer of Key Corp, in Albany, N.Y., thinks "mortgage banking will follow the pattern of credit cards—a business whose meaningful volume becomes concentrated in a relatively small number of hands."[14]

The crucial hurdle for commercial banks desiring to expand into new businesses is the opposition of other financial firms such as security houses and insurance companies. (The business area of commercial banking, a major and important issue in regulations in recent years, is discussed in **Chapter Five**.)

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[13]"The Most Profitable Banks by Five-Year ROA," *ABA Banking Journal*, July 1993, 54.

[14]Ibid.

Table 4-10

Money Center Revenue Mix
(In Percentages, Year-to-Date June 30, 1992)

	Net Interest Income	Trading Related	Other Noninterest Income
Bankers Trust	27	32	41
J.P. Morgan	41	22	37
First Chicago	46	4	50
Citicorp	47	7	46
Continental Bank	56	5	39
Chemical Banking	59	11	30
Chase Manhattan	60	5	35
BankAmerica	66	4	30

Source: Moody's Investors Service, "U.S. Money Center Banks," *Moody's Industry Outlook*, February 1993, 22.

The departure of commercial banks from traditional banking business may raise additional risks to the stability of the commercial banking industry. Although fees and commissions on deposit-account services and credit card and trust business are relatively stable sources of income, securities trading and foreign exchange trading are often regarded as risky: they involve so-called market risk and may cause large losses to commercial banks if market interest rates or foreign exchange rates move in an unexpected direction. As **Tables 4-11** and **4-12** show, income from security trading and foreign exchange trading has fluctuated considerably in recent years, but their relative importance of these businesses is still small, except for a few money center banks. **Table 4-13** shows the amount of income from securities trading and foreign exchange trading on their own accounts and the ratio to net interest income in 1992. Although the ratio of both kinds of income was greater than 10 percent of net interest income at the nine money center banks, more than half of the amount was earned by the two top banks in each business. (Of a total of $2,490 million securities trading income, $959 million was earned by J.P. Morgan and $565 million by Bankers Trust; of a total of $2,695 million foreign exchange trading income, $1,005 million was earned by Citicorp and $476 million by Chemical Banking Corporation.)

A similar concern has arisen about risks involved in the business of derivatives such as swaps, options, and futures, innovative financial products whose values derive from some underlying asset, such as stocks, treasury bonds, foreign currencies, or commodities.

Table 4-11

Securities Trading Income
($U.S. Millions)

	1988	1989	1990	1991	1992
Bankers Trust	221	284	601	957	565
Chase Manhattan	129	156	123	120	141
Chemical Banking	185	186	206	382	377
Citicorp	277	256	271	457	326
J.P. Morgan	210	450	921	1,297	959

Source: Salomon Brothers, "Securities Trading Income, and as a Percentage of Average Total Assets, 1988-92," *Bank Annual: 1993 Edition*, 32.

Table 4-12

Foreign Exchange Trading Income
($U.S. Millions)

	1988	1989	1990	1991	1992
Bankers Trust	154	297	425	272	331
Chase Manhattan	250	227	217	215	327
Chemical Banking	246	249	313	289	476
Citicorp	616	471	657	709	1,005
J.P. Morgan	187	130	170	85	262

Source: Salomon Brothers, "Foreign Exchange Trading Income, and as a Percentage of Average Total Assets, 1988-92," *Bank Annual: 1993 Edition*, 33.

Table 4-13

Securities Trading Income and Foreign Exchange Trading Income in 1992

$ U.S. Millions

	9 Money Center Banks	21 Super-Regional Banks	20 Regional Banks
Securities Trading Income	2,490	530	142
Foreign Exchange Trading Income	2,695	401	96

Percentages of Net Interest Income

	9 Money Center Banks	21 Super-Regional Banks	20 Regional Banks
Securities Trading Income	11.1	1.3	1.4
Foreign Exchange Trading Income	12.0	1.0	0.9

Source: Salomon Brothers, "Net Interest Revenue, and as a Percentage of Average Total Assets and Average Earning Assets, 1988-92," *Bank Annual: 1993 Edition*, 26, "Securities Trading Income, and as a Percentage of Average Total Assets, 1988-92," 32, and "Foreign Exchange Trading Income, and as a Percentage of Average Total Assets, 1988-92," 33.

Although derivatives were originally developed to protect financial institutions and their customers from fluctuations in interest rates, foreign exchange rates, and stock prices, the rapid expansion of derivatives transactions has raised concerns that they may have hidden risks. At a conference sponsored by the Kansas City Federal Reserve Bank, Federal Reserve Board Chairman Alan Greenspan said that derivatives should allow banks to better manage risk and so should help to insulate the payment system from financial and real shocks, but that it is by no means clear whether recent financial market innovations have increased or decreased the inherent stability of the financial system.[15]

The fear of risks incurred by derivatives comes mainly from their complex structure, to which computer technology is indispensable. In the case of treasury bond options, for example, the prices (premiums) of options are not determined only by the spot prices of

[15]Kenneth H. Bacon, "Greenspan Says New Ways to Limit Risk from Financial Markets Are Needed," *Wall Street Journal*, Aug. 23, 1993, A4.

treasury bonds. The volatility of treasury bond prices, the length of option period, and forward prices also affect the theoretical premiums through a complicated formula. The premium of a call option that has a right to buy treasury bonds at a certain price (the striking price) does not fluctuate so when the spot price is considerably below the striking price, because the option then has little value. When the spot price nears the striking price, the option premium will surge and begin to fluctuate as the spot price goes up and down (**Figure 4-1**). In other words, the risk involved in the call option changes with fluctuations in the spot price.

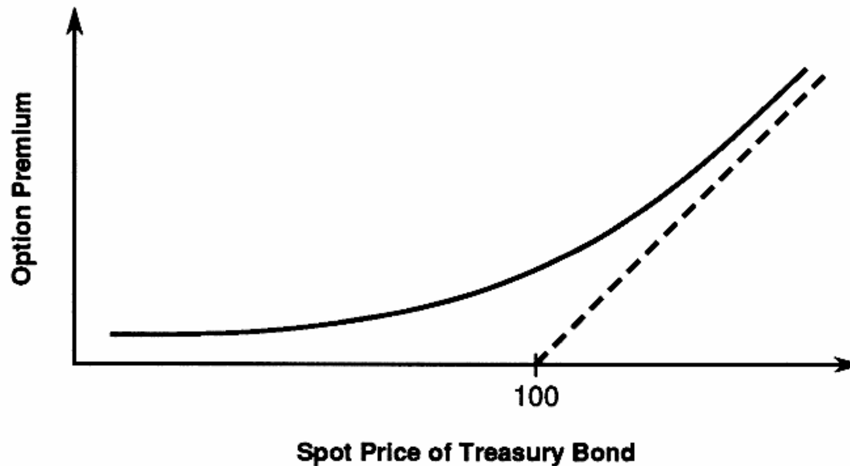

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Figure 4-1

Premium of Treasury Bond Call Option Striking Price: 100

The complexity of derivatives makes it difficult for commercial banks to establish adequate internal controls, and both federal regulators and Congress have become concerned about the need for regulation of derivatives. The Group of Thirty, a Washington-based group of high level international bankers and former government officials, issued a report that offers 20 recommendations to dealers and their clients with the aim of improving industry practices and fending off regulation. The recommendations include strengthening the role of senior management, providing additional disclosure, and implementing more rigorous accounting techniques for derivatives.[16] "Regulators generally welcomed the banking industry's resolve to become more responsible in managing its derivatives risk."[17] Wendy Lee Gram, who

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[16]Steven Lipin, "Banks Try to Avoid Rules on Derivatives," *Wall Street Journal*, July 22, 1993, C1.

[17]Ibid.

chaired the Commodity Futures Trading Commission from 1988 to 1993, wrote in the *Wall Street Journal*, "I hope these recommendations will be viewed as suggestions but will not become codified by regulators or industry groups. It is important that there be a continuing evolution of practices and principles to meet ever-changing markets and products."[18]

The fees and commissions business is generally considered safer than lending and trading-related businesses, but getting corporate clients to pay sufficient fees has proved increasingly difficult as the competition among commercial banks and with other financial firms grows fiercer. In the wholesale payment business, for example, which "has reached a higher level of automation than the retail payment businesses,"

> wholesale customers of banks have gained immeasurably in their control of their money. They now make more payments, faster and more securely, and know more about their bank account than they ever did in the paper-based world. They have more choice, more flexibility, and more power. They have more data that may help them in other parts of their business and in gaining the upper hand against the banks. For the banks that compete in wholesale payments, it is the opposite side of the coin. Margins are constantly under pressure because of overcapacity.[19]

To compete for fee business with corporate clients, commercial banks tend to raise the rates of fees for retail clients. "The cost of an average account rose from $155.30 in 1990 to $184.16 in 1993, according to a study issued [in the] summer [of 1993] by the Consumer Federation of America and the U.S. Public Interest Research Group (USPIRG). The 18.5% increase was nearly twice the rate of inflation."[20] The increase reflects higher fees for a bounced check or stopped payment, automatic fund transfer from a savings account to cover a checking overdraft, and the use of "foreign" ATMs (those not owned by the bank). Further, some commercial banks began to charge for requiring in-person assistance at a branch if the question or transaction could have been handled instead by telephone service; other banks make customers help underwrite the cost of FDIC insurance.[21] Whether further rules are necessary for consumer protection may become an issue if this trend—reduced fees for corporate clients, increased fees for retail clients—continues and expands.

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[18]Wendy Lee Gramm, "In Defense of Derivatives," *Wall Street Journal*, Sept. 8, 1993, A12.

[19]Steiner and Teixeira, "Technology in Banking," 169.

[20]Pam Black, "Getting Soaked by Soaring Bank Fees?" *Business Week*, Sept. 20, 1993, 108.

[21]Ibid.

4.3 Trends of Mergers and Acquisitions

The number of mergers among U.S. commercial banks has exceeded three hundred annually since 1983, while the total number of U.S. commercial banks decreased from 14,385 in 1975 to 11,465 in 1992 (**Table 4-14**). In 1991, the value of merger deals reached its highest level, $21 billion, reflecting such large mergers as BankAmerica-Security Pacific, Chemical- Manufacturers Hanover, and NCNB-C&S/Sovran. In 1992, though the level decreased from the previous year, the value recorded was still high, $14 billion (**Table 4-15**). "There is no argument that there will be further consolidation and rationalization in the overbanked US."[22]

In 1985, the Supreme Court supported the right of states to permit interstate business by regional banks. This decision was meant to override the McFadden Act of 1927, which prohibits interstate banking. Since 1985, "the super-regionals have been able to build up cross-state-border businesses as a result of agreements between individual states—from which, with few exceptions, the New York based banks were formally excluded because of populist worries that they would be able to stomp all over the country."[23] As a result, some super-regional banks have expanded their business through mergers and acquisitions and have surpassed some money center commercial banks in capital and assets (**Table 4-16**). The Standard & Poor's Corporation expects that "over the coming decade, medium sized regional banks with assets of $1 billion to $15 billion will likely be absorbed by the super-regionals (those with assets of $25 billion or more)."[24]

A reduction in operating expenses is the most popularly expected reward of a merger. If the merger is between banks in the same regional market, an effective way to reduce operating expenses is through office consolidation, common use of computer systems, and so on. Since its merger with the Manufacturers Hanover Corporation on December 31, 1991, the Chemical Banking Corporation has achieved remarkable reductions in operating costs. The targeted cost savings through merger was $750 million, and the company reported a cost saving of $280 million in 1992 and $235 million in the first six months of 1993—that is, almost 70 percent of the targeted cost reduction was achieved a year and a half after the merger. Staff reductions related to the merger amounted to 5,450 in 1992.[25]

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[22]Michael Blanden, "Who Has the Muscle?" *The Banker*, June 1993, 40.

[23]Ibid.

[24]Standard & Poor's Industry Surveys, Banking and Other Financial Services Basic Analysis, Nov. 12, 1992, 24.

[25]Chemical Banking Corp, Annual Report 1992 and Form 10-Q for the quarter ending June 30, 1993.

Table 4-14

Number of Mergers and Total Banks

Year	Mergers	Total Banks
1992	429	11,465
1991	448	11,926
1990	392	12,345
1989	411	12,713
1988	597	13,137
1987	545	13,722
1986	339	14,209
1985	330	14,417
1984	329	14,496
1983	352	14,469
1982	283	14,451
1981	214	14,415
1980	132	14,435
1975	93	14,385
1970	148	13,511

Note: Mergers do not include those caused by failures.

Source: Federal Deposit Insurance Corporation, Division of Research and Statistics, "Changes in Number of Insured Commercial Banks and Trust Companies," *Historical Statistics on Banking 1934-1992*, 6.

The advantages derived from mergers are not limited to cost reductions. It is said if merged banks can strengthen access to money markets and gain a dominant position in lending and taking deposits, they can reduce funding costs, raise loan rates, and thus improve their net interest margin. Mergers may also make it possible to broaden the range of services offered, because the different services previously provided by each bank can be distributed through a combined network after merger. Finally, new services that require substantial investments in computer facilities may be enabled by the merger, because only large banks can afford to have such large facilities (see **Chapter Two**).

Table 4-15

Value of Announced Merger Deals
($U.S. Billions)

1992	14
1991	21
1990	4
1989	11
1988	10
1987	17
1986	17

Sources: Standard & Poor's Corp, "Banking and Other Financial Services Basic Analysis," *Standard & Poor's Industry Surveys*, November 12, 1992, 22. Standard & Poor's Corp, "Banking and Other Financial Services Current Analysis," *Standard & Poor's Industry Surveys*, February 25, 1993, 5.

A recent study has shown that in many cases mergers instead reduced the profitability of commercial banks. Dwight B. Crane and Jane C. Linder of the Harvard Business School studied forty-seven mergers in New England that occurred during 1982-87 and compared the profitability measured by operating income per assets of the merged commercial banks with that of other commercial banks.[26] The study showed that mergers of newly acquired banks could not improve profitability relative to their competitors, while mergers of intraholding companies could do so. The latter type of mergers could perform better through improvement of net interest income, but both types of merger caused significant losses of business to competitors and slowed the growth of operating income and assets. Unexpectedly, the slowed growth of assets after mergers of both newly acquired banks and intraholding companies increased noninterest expense per assets above the industry average.

> It is likely that some of the loss in assets and deposits was deliberate as bankers attempted to discourage unprofitable accounts and improve net interest margins through the repricing of loans and deposits. However, some loss of business was probably unintentional as customers

[26] Dwight B. Crane and Jane C. Linder, "Bank Mergers: Integration and Profitability," *Journal of Financial Services Research*, 7 (1992), 35-55.

Table 4-16

Top Ten U.S. Banks
($U.S. Billions)

1993	Capital	Assets
1. BankAmerica (SF)	8.6	179.4
2. Citicorp (NY)	7.8	211.9
3. Chemical (NY)	7.4	138.3
4. NationsBank (Charlotte)	7.2	119.2
5. J.P. Morgan (NY)	6.8	101.9
6. Chase Manhattan (NY)	4.8	95.3
7. Banc One (Columbus)	4.7	61.2
8. PNC Financial (Pittsburgh)	3.7	51.4
9. Bankers Trust (NY)	3.6	72.2
10. First Union (Pittsburgh)	2.9	51.1

1983	Capital	Assets
1. Citicorp (NY)	4.8	120.7
2. BankAmerica (SF)	4.6	115.2
3. Chase Manhattan (NY)	3.3	77.1
4. J.P. Morgan (NY)	2.7	54.7
5. Manufacturers Hanover (NY)	2.5	60.1
6. Chemical (NY)	1.9	45.5
7. First Interstate (LA)	1.8	39.3
8. Continental Illinois (Chicago)	1.7	42.2
9. Bankers Trust (NY)	1.6	37.8
10. First Chicago (Chicago)	1.5	34.4

Source: Michael Blanden, "Who has the muscle?" *The Banker*, June 1993, 37.

experienced operating problems and confusion associated with the merger, or reduced deposits to stay within the $100,000 insurance limit.[27]

After merging with Security Pacific, BankAmerica suffered a departure of customers.

U.S. Filter Corp. said it switched to First Interstate Bancorp after BankAmerica refused to accept Security Pacific's paperwork, thereby causing months of delay in securing a credit line. The Men's Wearhouse turned to NationsBank partly because it had qualms about BankAmerica's customer service. And the Software Supermarket said it

[27]Ibid.

> switched after BankAmerica Canceled overdraft protection, charged excessive fees and called a loan without explanation.[28]

According to Lewis Coleman, chief financial officer of BankAmerica:

> Loan volume is a problem, and it's clear that if it remains as low as it is today, at some point we will have to make more expense cuts.[29]

The boom in mergers and acquisitions in the commercial banking industry since the late 1980s occurred simultaneously with the decline in commercial banks' market share of financial services. So long as the pie is shrinking, commercial banks that compete in the same market may choose to merge rather than continue competition until some of them fail. Mergers aimed solely at cost reduction cannot increase revenue, but will only bring about branch consolidation and the firing of employees. Unless commercial banks can achieve more than cost cutting through merger or acquisitions, this boom will be regarded as a phenomenon illustrative of the declining share of commercial banks in U.S. financial services.

Unlike mergers aimed only at cost cutting, the merger between KeyCorp of Albany, N.Y., and Society Corp of Cleveland, announced on October 4, 1993, was intended to create new businesses and revenues for both banks. KeyCorp has a broad branch network in small towns across the northern tier of the United States, while Society Corp's strength lies in nontraditional commercial banking businesses such as trust and investment management. Thus, their business regions do not overlap. A great variety of services developed by Society Corp are expected to be distributed through the network established by KeyCorp. According to Victor Riley, chairman and chief executive officer of KeyCorp, "It was apparent that a continuation of expense reduction is not something that either of us could live on forever;"[30] and according to Robert Gillespie, chairman and chief executive officer of Society Corp, "The thing that really drives us here is not so much the cost savings, although they're significant, but the marketplace synergy."[31]

The targets of acquisitions by commercial banks are not limited to the industry. In December 1993, Mellon Bank agreed to acquire the Dreyfus Corp., the sixth largest mutual fund company in the United States. While that acquisition will provide Mellon Bank with substantially more fee-producing businesses, which are less risky than its lending businesses,

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[28]Ralph T. King Jr., "A Bad Buy?: BankAmerica Finds It Got a Lot of Woe With Security Pacific," *Wall Street Journal*, July 22, 1993, A6.

[29]Ricardo Sookdeo, "Too Much at the Wrong Time," *Fortune*, Aug. 9, 1993, 71.

[30]Richard Waters, "US Banks Confirm Merger," *Financial Times*, Oct. 5, 1993.

[31]Steven Lipin, "KeyCorp and Society Hope Differences Become Asset," *Wall Street Journal*, Oct. 5, 1993, B4.

Dreyfus hopes to capitalize on Mellon's back-office technology strength, particularly to handle the growing tax-free savings business.[32]

A new road to recovery may be created by the U.S. commercial banking industry if these mergers can achieve success as expected and other commercial banks follow with mergers aimed at an expansion of business.

4.4 Economies of Scale and Scope

Economies of scale and scope let a provider of services reduce the cost per service by increasing the volume of a service or expanding the variety of services. In the commercial banking industry, recent trends, such as diversification of income sources and increasing mergers and acquisitions, illustrate a belief in economies of scale and scope in financial services.

4.4.1 Economies of Scale

According to statistics of the Federal Reserve Board, smaller banks have shown higher profitability than larger banks, especially since 1989 (**Table 4-17**). At smaller banks, the ratio of retail loans to total loans has been greater than at larger banks (**Table 4-18**). Because retail loans produce higher margins for lenders than wholesale loans, smaller banks have achieved higher net interest margins per assets than larger banks (**Table 4-19**). While since 1987 larger banks have reported a large amount of credit loss provisions for lending to LDCs, highly leveraged transactions, and commercial real estate, smaller banks have suffered less credit loss during the same period (**Table 4-20**). The noninterest expense per assets of small and medium banks was larger than that of large banks until 1989, but since 1991 that trend has been reversed, partly because of increased net operating losses on foreclosed properties at large banks (**Table 4-21**).

Variations in profitability even within the top tiers in each size class (**Table 4-22**) are larger than across classes (**Table 4-17**). These statistics indicate that large banks are neither more profitable nor more cost-effective than small banks.

The comparison of average figures for large and small banks omits from examination several services or operations in which economies of scale are significant. The important factor for economies of scale in financial services has been the active use of computer and communications facilities. As discussed in **Chapter Two**, commercial banks have expanded the use of computer and communications technology in several businesses, including back

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[32]Gabriella Stern, Robert McGough, and Sara Calian, "Mellon to Buy Dreyfus for $1.7 Billion," *Wall Street Journal*, Dec. 7, 1993, C1, C24.

Table 4-17

Return on Assets and Return on Equity
(In Percentage)

Return on Assets
(in percentage)

	1985	1986	1987	1988	1989	1990	1991	1992
Small*	.74	.58	.62	.72	.87	.79	.80	1.08
Medium**	.84	.77	.64	.75	.73	.55	.61	.91
Large***	.73	.68	-.27	.71	.51	.24	.50	1.01
Ten Largest	.47	.47	-.70	1.07	-.22	.47	.21	.65

Return on Equity
(in percentage)

	1985	1986	1987	1988	1989	1990	1991	1992
Small	9.02	7.11	7.49	8.62	10.12	9.08	9.19	12.11
Medium	12.96	11.50	9.45	11.18	10.65	7.83	8.39	11.90
Large	13.19	12.05	-5.02	13.94	9.31	4.25	8.10	14.66
Ten Largest	9.87	9.60	-15.73	22.85	-4.39	10.14	4.25	11.87

Notes: *Banks with less than $300 million in assets. **Banks with $300 million to $5 billion in assets. ***Banks with more than $5 billion in assets, excluding ten largest.

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

Table 4-18

Consumers and 1-4 Family Residential Loans
as a Percentage of Total Loans

	1985	1986	1987	1988	1989	1990	1991	1992
Small	44	45	46	47	47	48	48	48
Medium	36	38	39	41	42	44	45	48
Large	24	25	27	28	32	33	36	38
Ten Largest	17	18	19	20	22	25	27	29

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

Table 4-19

Net Interest Margin as a Percentage of Average Net Consolidated Assets

	1985	1986	1987	1988	1989	1990	1991	1992
Small	4.23	4.04	4.03	4.06	4.18	4.08	4.09	4.34
Medium	3.82	3.82	3.85	3.89	3.87	3.85	3.99	4.22
Large	3.28	3.19	3.16	3.17	3.29	3.27	3.46	3.85
Ten Largest	2.81	2.77	2.67	3.03	2.81	2.68	2.92	3.18

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

Table 4-20

Credit Loss Provisions as a Percentage of Average Net Consolidated Assets

	1985	1986	1987	1988	1989	1990	1991	1992
Small	.81	.88	.67	.55	.49	.50	.51	.39
Medium	.59	.78	.81	.70	.77	1.09	1.04	.77
Large	.69	.81	1.77	.62	1.15	1.30	1.21	.81
Ten Largest	.72	.78	2.05	.39	1.49	.76	1.20	1.09

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

office transactions processing, delivery of services, credit and market risk management, marketing, and development of new services. A high initial investment in data, programming, and experience is necessary, but the cost of drawing on the resultant information—in information-oriented services, such as servicing loans and other extensions of credit; investment or financial advising; providing bookkeeping or data processing services; and management consulting for unaffiliated banks—is low.[33] This would be equally true for other computerized businesses such as credit risk management and marketing for retail lending, in which economies of scale have become significant and large banks have gained advantages over small ones.

[33]Ginsburg, *Interstate Banking*, 57.

Table 4-21

Noninterest Expenses as a Percentage of Average Net Consolidated Assets

	1985	1986	1987	1988	1989	1990	1991	1992
Small	3.44	3.47	3.43	3.43	3.48	3.48	3.62	3.65
Medium	3.66	3.63	3.57	3.56	3.49	3.52	3.73	3.91
Large	3.02	3.10	3.24	3.18	3.35	3.46	3.78	4.00
Ten Largest	2.77	3.01	3.20	3.30	3.42	3.49	3.79	3.83

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

Table 4-22

The Most Profitable Banks by Five-Year Return on Assets, 1988-92 (In Percentage)

	Small Banks*		Medium Banks**		Large Banks***	
	Rank	ROA	Rank	ROA	Rank	ROA
	1	3.78	1	2.77	1	2.23
	50	1.90	50	1.83	25	1.37
Difference		1.88		0.94		0.86

Notes: *Banks with less than $100 million in assets. **Banks with $100 million to $1 billion in assets. ***Banks with more than $1 billion in assets, excluding ten largest.

Source: Sheshunoff Information Services Inc., Austin, Texas. Quoted in "The Most-Profitable Banks by Five-Year ROA," *ABA Banking Journal*, July 1993, 48-51.

As a result, a number of small banks have sold their credit card portfolios to larger competitors which can more efficiently bring that service to their customers,[34] while small banks have benefited from communications systems that facilitate the purchase of (back office)

[34]Banking and Other Financial Services Basic Analysis, 24.

processing services from large-scale producers.[35] Securities trading and foreign exchange are dominated by a small number of banks (**Table 4-13**). The number providing custodial services for pension plans and mutual funds is fairly small, particularly in the case of global custodial services.[36] As competition in wholesale lending grows fiercer, large banks are devoting more energies to retail lending by using advanced computer systems for transactions processing, marketing, and risk management (**Table 4-18**).

4.4.2 Economies of Scope

In 1990 Banc One Corp, the holding company of Bank One, combined many nontraditional and specialized services under a new company called the Banc One Diversified Services Corporation. In 1993 this Corporation opened more than four hundred Personal Investment Centers in existing Bank One offices to offer a full range of nontraditional financial services along with existing products already offered through the branch network. The nontraditional services include bank-managed and other mutual funds and some types of insurance products.[37] Banc One Corp's

> diversified, but uniform product structure enables affiliates to offer individual or packaged services that meet a wide variety of banking needs while providing processing economies of scale.... A common product structure also includes a more effective use of advertising across markets and increases awareness to the Bank One brand name. As a result, we can more effectively capture the attention of current and potential customers and also attract new business.[38]

In line with the aims of Banc One Corp, economies of scope are expected to be strong when commercial banks can operate or distribute new financial products through their existing properties, including branches, computer facilities, and communications network (**Table 4-23**). Recent advances in technology have led to the development of computer and communications facilities to deal with or deliver various kinds of financial products. Back-office processing operations, for instance, are similar for a wide range of financial product and thus can be combined into a single process to service a whole range of products.[39] A number of commercial banks sell mutual funds through their ATMs; the marginal operating

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[35]M. Ellen Gaske, "Economies of Scale and Scope in Wholesale Financial Services," A Staff Study, Federal Reserve Bank of New York, May 1992, 80.

[36]Ibid., 77.

[37]Banc One Corporation, 1992 Annual Report, 13.

[38]Ibid., 14.

[39]Gaske, "Economies of Scale and Scope in Wholesale Financial Services," 82.

cost of mutual fund sales through existing ATM networks will be much lower than the cost of establishing a separate and independent network.

Table 4-23

Noninterest Income as Percentage of Net Interest Income

	1985	1986	1987	1988	1989	1990	1991	1992
Small*	20	22	22	23	24	25	27	26
Medium**	37	37	36	37	36	39	40	40
Large***	40	45	49	50	57	57	59	58
Ten Largest	49	58	73	69	78	84	81	81

Notes: *Banks with less than $300 million in assets. **Banks with $300 million to $5 billion in assets. ***Banks with more than $5 billion in assets, excluding ten largest.

Source: Allan D. Brunner and William B. English, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 1992," *Federal Reserve Bulletin*, July 1993, 666-673.

Chapter Five

Issues in Public Policy and Regulation

5.1 Emerging Issues

Developments in information technology and changes in regulations have expanded the participants in U.S. financial services and financial markets. Nonbank financial firms have entered such traditional commercial banking businesses as fund gathering and lending. Through borrowing and investing, even nonfinancial firms and individual investors have developed a closer relationship to capital markets than before. At the same time, this increase in participants has created new risks and frictions.

The following main issues are discussed in this chapter:

> (*i*) In the present circumstances, are the interests of consumers and small- and medium-size firms protected?
>
> (*ii*) Will the decline of the commercial banking industry bring instability into the national financial system or into the economy at large?
>
> (*iii*) What kind of problems will be created by the expansion of commercial banks into new businesses, such as equity and bond underwriting, mutual fund sales, and insurance?

These issues arise from conflicts of interest among major players, including commercial banks, other financial institutions, nonfinancial corporations providing financial services, wholesale and retail users of financial services, and regulatory authorities. Because most old rules and legislation are no longer effective for dealing with these issues, each player wants new legislation or regulatory action favoring its own interests. Any modification to or abolition of legislation inevitably produces losers as well as winners, and potential losers will resist possibly disadvantageous changes.

5.2 Protection for Individuals and Small Businesses

5.2.1 Negative Impact on Individuals and Small Businesses

Competition among commercial banks and other financial institutions has created a variety of ways to invest and borrow, from which both individuals and small businesses have benefited as have large corporations. Mutual funds and pension funds offer individuals substitutes for deposits and deposit-like products sold by commercial banks or insurance companies. The expansion of corporate bond and commercial paper markets enabled small- and medium-size firms to raise funds by selling securities.

Some recent phenomena indicate that the interests of individuals or small businesses are damaged when competition among financial industries intensifies.

Although federal funds rates and commercial paper interest rates have dropped more than 4 percent since the end of 1990 and commercial banks and corporate borrowers with access to money or capital markets enjoyed the rewards of the lowered rates, the average interest rate on credit card loans stuck at around 18 percent during 1991 and remained over 17 percent at mid-1993 (**Table 5-1**).

Table 5-1

Interest Rate Comparisons

	Fed Fund	Three-Month Commercial Paper	Credit Card
May 1993	3.00	3.14	17.15
Feb. 1993	3.03	3.18	17.26
Nov. 1992	3.09	3.66	17.38
Aug. 1992	3.30	3.38	17.66
May 1992	3.82	3.88	17.97
Feb. 1992	4.06	4.11	18.09
Nov. 1991	4.81	4.98	18.19
Aug. 1991	5.66	5.72	18.24
May 1991	5.78	5.92	18.22
Feb. 1991	6.25	6.49	18.28
Nov. 1990	7.81	7.91	18.23

Sources: Board of Governors of the Federal Reserve System, "Interest Rates in Money and Capital Markets" and "Terms of Consumer Installment Credit," *Annual Statistical Digest 1991*, 63, 93, and *1992*, 64,93; *Federal Reserve Bulletin*, April 1991, A16, A39, August 1993, A26, and September 1993, A39.

When interest ceilings on bank deposits were set below market rates in the 1970s they created incentives for banks to compete for customers on a nonprice basis by offering additional services at below-cost prices.[1] In contrast, as described in **Chapter Four**, the cost of an average account for an individual increased 18.5 percent per year—nearly twice the rate of inflation—during 1990–93, while fees for corporate clients, such as the wholesale payment fee, were constantly under downward pressure because of severe competition.

According to Shoichi Royama, professor of economics at Osaka University, "In the U.S., marketing strategies in financial transactions and the financial services market have

[1]Gaske, "Economies of Scale and Scope in Wholesale Financial Services," 71.

grown more sophisticated through the intense competition in the financial services industry. As a result, financial firms tend to provide inferior services to customers that do not respond elastically to changes in prices. The inferior services include closing branches, compulsory ATM use, and higher fees.... How to prevent diminished service may become an important issue also in Japan."[2]

The experience of asset deterioration in the United States during the late 1980s and the increasingly strict examination of asset quality by federal regulators have made commercial banks negative toward lending to small businesses and to particular industries, such as real estate developers. J. William Sharman, Jr., president of the Lancaster Group Inc., Houston, wrote in *Business Week*, "A typical banker's response to any small business, no matter how well-collateralized and how good its project is, will be, 'What is the secondary source of payment?' Quick interpretation: 'We'll lend you a million dollars, if you have a million dollars in additional liquid security apart from your business.'"[3]

The growing popularity of mutual funds among individual investors has given rise to concern about whether such investors truly understand the risks involved, especially for investments in other than money market mutual funds. Unlike commercial bank deposits, which are insured by federal agencies, some mutual funds are exposed to credit or market risk. Junk bond mutual funds, which bear a higher return than money market mutual funds as long as the default ratio of underlying assets remains moderate, involve the credit risk of so-called speculative grade investments. The return on stock mutual funds fluctuates with the stock market. In the 1980s funds that involve derivatives also began to be sold to individuals. Most individual investors know less about credit and market risks than institutional investors. They may buy high-risk, high-return mutual funds without a proper understanding, especially when the funds are available through commercial bank branches, believing they were federally insured.

5.2.2 Regulatory Actions

Some regulatory actions have been taken and others considered in response to the negative phenomena sketched above. Although the share of the commercial banking industry in financial services is declining, consumers and Congress still expect the industry to fulfill its responsibility to the public interest. Probably because of its historically established position in the financial system, its broad branch networks, and its ability to operate a variety of services to consumers, the commercial banking industry is expected to continue to bear that responsibility, which sometimes becomes burdensome. Under some regulatory actions

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[2]Shoichi Royama, *Kinyu Jiyuka* [Liberalization in Finance] (Tokyo: Tokyo University Press, 1986), 88.

[3]J. William Sharman, Jr., "Banks Are Choking Small Business," *Business Week*, Oct. 11, 1993, 7.

intended to protect the interests of individuals and small businesses interests, commercial banks are potentially losers.

In a move to ease the stagnant high credit card loan interest rate, on November 13, 1991, the U.S. Senate passed an amendment to a pending banking bill to limit credit card interest rates charged by banks and retailers. The proposed legislation—which was struck from the final bill signed by the President—would have limited those charges to no more than four percentage points above the rate the Internal Revenue Service charges on overdue taxes. With the IRS rate at 10 percent, the Senate action would have resulted in lowering credit card interest rates to 14 percent.[4] The commercial banking industry intoned "consumer protection" when it opposed the Senate action.

> First Chicago, one of the largest credit card lenders in the U.S. said, "this action by the Senate could have the effect of severely decreasing availability of credit in the country, which would drive us further into the recession." The company went on to state that about 50% of its credit card account would be economically infeasible under the proposal, and that credit would be cut off to all but an elite class of customers because banks would be forced to eliminate any semblance of risk in their portfolios.[5]

The Community Reinvestment Act of 1977 (CRA) was passed to help commercial banks meet the credit needs of their local communities. Bank examiners are required to consider a bank's performance in meeting those needs, especially in low- and moderate-income areas. A local community is considered the "contiguous areas surrounding each office or groups of offices." By this Act, commercial banks were obliged to lend some portion of their funds, to set up new ATMs, or to expand activities in their local communities in any other way, regardless of profitability. One major complaint of commercial banks against the CRA is that only the commercial banking industry bears the obligation. Replying to this complaint, Eugene A. Ludwig, Comptroller of the Currency, said,

> To date, of all the financial services sectors, banking has carried by far the heaviest load of social responsibilities. I believe the unmistakable trend is toward a more equitable distribution of that load. The signs are already apparent. In recent years, legislation has imposed new reporting burdens on mortgage banks, new low income lending targets on Fannie Mae and Freddie Mac. And several congressional committees are now looking into redlining in the insurance industry. I believe we are likely to see continuing extensions to non-bank financial services providers of

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[4] "Banking and Other Financial Services Basic Analysis," 31.

[5] Ibid.

> at least some of the social obligations that have been imposed on banks."[6]

On the other hand, Jonathan R. Macey, professor of law at Cornell University, asserted that the CRA has not benefited low-income people after all and that extending its reach to mutual funds and other nonbank competitors is a bad idea.

> The reality is that the CRA has made the credit crunch in low-income areas worse, not better. Because it is easier to meet the credit needs of a community with fewer poor people, banks in poor areas have a greater burden under CRA than banks in affluent areas. The CRA provides a major disincentive for banks in affluent areas to expand into poor areas.... And extending this regulatory burden to banks' competitors will only extend existing inefficiencies and counterproductive policies to other sectors of the financial system.[7]

In mutual fund sales, commercial banks are regulated more strictly than security houses or mutual fund investment companies. In July 1993, the Comptroller of the Currency issued guidelines to commercial banks on mutual fund sales, recommending that banks require customers to sign statements saying they understand that mutual funds are not federally insured, are not obligations of the bank, and involve market risks, including the possible loss of principal. In October, more rigid legislation was proposed in Congress, under which, for example, commercial banks would have to sell uninsured funds in areas separate from the teller windows where they take insured deposits. "Such a bill, if enacted, could lead to hundreds of pages of regulation and millions of dollars in additional costs," complained Donald Ogilvie, executive vice president of the American Bankers Association. "All this would be unnecessary since there is no evidence of abuses, and since the regulators and the industry are working together aggressively to achieve the same goals."[8]

5.2.3 Lifting Regulations on Commercial Banks

In contrast, regulators often try to protect the interests of individuals or small businesses through lifting or loosening regulations on commercial banks, and in that case commercial banks would be winners.

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[6]Remarks by Ludwig before the Merrill Lynch Financial Services Conference, New York, N.Y., Sept. 13, 1993, 6.

[7]Jonathan R. Macey, "Porkbarrel Banking," *Wall Street Journal*, July 19, 1993, A10 (NEXIS).

[8]Quoted in Kenneth H. Bacon, "Mutual Fund Rules Mulled by Congress," *Wall Street Journal*, Oct. 20, 1993, C20.

In statements to the Congress, Alan Greenspan, chairman of the Federal Reserve Board, said, "The other critical external force contributing to reduced credit availability at small businesses is recent banking legislation—the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).... All have diverted management resources, increased burdens and costs, and created uncertainties that could only make bankers more reluctant to take risks."[9]

When a commercial bank sells small business loans in the secondary market, it often sells them with recourse, meaning that the banks are responsible for some of the loss if the borrower defaults. Under the rules in 1993, a commercial bank must maintain capital equal to 8 percent of the entire value of a loan it sells, even if it sells the loan with partial recourse. To boost credit for small business, the Federal Reserve and the Treasury are considering changing the rules, so that commercial banks will have to hold capital only against the portion of a loan subject to recourse.[10]

Some people argue that restrictions on securities business, insurance sales, and interstate branching should be removed for the consumer's benefit. According to Ludwig, Comptroller of the Currency,

> You would think that a serious policy discussion of these laws would focus on how they affect consumers and the economy. Oddly, and sadly, however, the debate over these restrictions—at least recent years—has been framed almost entirely in terms of whether changes in these laws and regulations would be good or bad for banks.... To my mind, the argument that selling insurance creates safety and soundness problems for banks simply lacks credibility, while the argument that selling insurance would benefit consumers seems virtually self-evident.[11]

Paul S. Calem, senior economist and research advisor, Research Department, Federal Reserve Bank of Philadelphia, argued:

> Removal of legal barriers to interstate branching would benefit consumers of banking services. Consumers in multistate areas would gain more convenient access to their accounts and related services. In addition, elimination of these barriers would enhance competition in banking, benefiting consumers through more favorable interest rates and

[9]Statement made before the Committee on Small Business, U.S. House of Representatives, March 25, 1993, *Federal Reserve Bulletin* (May 1993), 475.

[10]Kenneth H. Bacon, "Regulators Seek to Boost Lending to Small Business," *Wall Street Journal*, Sept. 10, 1993, A2.

[11]Remarks by Ludwig before the Merrill Lynch Financial Services Conference, 4.

fees. Also, interstate branching may facilitate the importation of funds into areas where credit demand is particularly strong.[12]

5.2.4 Winners and Losers

When Congress or federal regulators try to protect the interest of individuals and small business through additional regulation of commercial banks, the banks are the losers. If regulations were extended to nonbank financial firms, such as mutual funds and security houses, those firms also would be losers. Winners escape regulation.

If such regulations as a capital requirement or restrictions on products and services are lifted from commercial banks to benefit individuals and small businesses, the banks might be winners and the relative position of nonbank competitors would be weakened.

When regulators attempt to protect the "consumer benefit" through additional regulation of financial firms, the impact on individuals and small businesses is mixed. New regulations often bring unexpected effects. People in the commercial banking industry have insisted that legislation to limit credit card interest rates may decrease the availability of credit to low- and middle-income families. The CRA is also criticized as worsening the credit crunch in low-income areas.

It seems more likely, however, that consumers would benefit from the removal of restrictions on services and on the geographic areas of commercial banks, because that might accelerate competition and lead to better services for consumers. When nonbank financial firms attack the expansion of commercial banks' business areas, they, too, defend "consumer benefit" (see section **5.4**).

"Consumer benefit" seems to have become a flag to raise at moments when the commercial banking industry or other financial service industries support or oppose a regulatory change. When the industries oppose a new rule, they usually do not say they oppose it "because it will damage our profit" but "because it will damage the consumer benefit" The impact of new legislation on consumers is sometimes interpreted in different ways, so that "consumer benefit" is a convenient term both to support and to oppose regulatory action. What is important is that consumers themselves should express the need for consumer benefit, not the providers of financial services.

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[12]Paul S. Calem, "The Proconsumer Argument for Interstate Branching," *Business Review* (May-June 1993), Federal Reserve Bank of Philadelphia, 27.

5.3 Stability of the Financial System

The decline of commercial banks and the trend toward disintermediation might, so it has been argued, destabilize the financial system, through volatility of the prices of stocks and bonds, an increase in corporate bankruptcies, spread of market and credit risk, and growing ineffectiveness of monetary policy.

5.3.1 Will Mutual Funds Bring a Panic?

The rapid growth of mutual funds has led to a fear among investors, analysts, and even sellers of the funds that falling stock or bond prices could create panic among investors that would accelerate the price drop. This fear stems chiefly from the lack of sophistication of most mutual fund investors and a feature particular to mutual funds, that investors can withdraw their funds at any time.

According to a survey by the Investment Company Institution, which represents the mutual fund industry, one in ten mutual fund owners bought their first fund between January 1991 and mid-1992, and many buyers during that period were not particularly wealthy—their median income was a modest $50,000 a year.[13]

Pressured by yield-hungry investors, mutual funds are more prone than pension funds or individuals to sell a stock when it begins to drop and to buy those on the rise, lest they miss the latest trend and investors flee. As a result, while mutual funds account for about 10 percent of all stock ownership, they account for 30 percent of the trading volume on the New York Stock Exchange, and, on hectic days, for more than 40 percent of all trades.[14]

According to Richard Hoffman, chief investment officer at Cowen & Company,

> I worry about 1-800-redemption. In the old days, an individual stock buyer would go to a broker, who would be a buffer and slow the process down. Now, if the market hits an air pocket, they can run helter-skelter and take the investment decision-making out of the hands of portfolio managers by overwhelming him with redemptions.[15]

Donald Straszheim, chief economist at Merrill Lynch, warned:

> Many of these investors are new to the equity markets, and they likely will get very nervous if the market begin to correct, and they may cut

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[13] Patrick Harverson, "The Feeling's Mutual," *Financial Times*, Oct. 5, 1993, 16.

[14] Leslie Wayne, "In Mutual Funds, Causing Concerns," *The New York Times*, Sept. 7, 1993, A1.

[15] Ibid.

> and run. I don't think at the moment that the market is all that vulnerable, but who knows what would set such a stampede off.[16]

Others insist that there is no need to worry about a panic. Roger Servison, head of retail sales at Fidelity, the largest mutual fund group in the US, says, "Eighty percent of all mutual fund owners have been through the '87 crash, the mini crash of '89 and the Russian coup of '91, and they have learned not to panic during sharp drops in the market."[17] Avi Nachmany, an analyst with the research firm Strategic Insight, which recently examined seven bear markets over a period of thirty years, says, "People redeem much less than they used to in a bear market. When people don't know what to do, they tend to do less."[18] According to the Investment Company Institute, holders of stock funds cashed in just 2 percent of their assets in the 1987 crash.[19]

However, Arthur Zeikel, president of Merrill Lynch Asset Management, the second largest mutual fund group in the United States, refutes such optimistic outlooks: "The 1987 experience was not a good prototype. It was a one-time shock to the system. My concern is what happens if you have a long term bear market like 1973-74. During the 1973-74 bear market, stocks lost about 40 percent of their value, on average."[20]

What can regulators do to avoid a panic in the future? Even if mutual funds do have the potential to bring about a market collapse, imposing restrictions on their trading volume or mechanism of redemption is unrealistic. Restrictions would constrain the activity of not only mutual fund companies but also stock and bond issuers and investors, all of which would oppose them.

The current way to avoid such a crisis is to make investors aware of the risks in mutual funds. In 1993 Representative Edward J. Markey (D.-Mass), who chaired the finance panel of the House Energy and Commerce Committee, prepared a bill to tighten standards on mutual fund management and advertising.[21]

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[16]Harverson, "The Feeling's Mutual," 16.

[17]Ibid.

[18]John Greenwald, "The Siren Call of Mutual Funds," *Time*, Nov. 8, 1993, 60.

[19]Ibid.

[20]Wayne, "In Mutual Funds, Causing Concerns," D4.

[21]Greenwald, "The Siren Call for Mutual Funds," 58.

Some key figures in the mutual fund industry agree with the necessity of informing investors about the risks of mutual funds. Ronald Lynch, chairman of the Investment Company Institute, said,

> It is imperative that we educate these first-time investors about both the risks and rewards of investing in long-term funds. In particular, bond fund investors must understand the impact of interest rate changes on the price of bond funds.[22]

John Bolge, chief executive the Vanguard Group, the third largest mutual fund seller in the United States, said, "Not enough people are aware of the risks. And if investors don't understand risk, they not only lose money, but they get mad, too."[23]

Further, mutual fund leaders have called on Congress to increase inspection by the SEC, though in other financial industries such inspections are usually hated.

Fear of a market crisis necessarily has a negative impact on the mutual fund industry. Investors may shift funds to other assets to avoid risk. Fear may lead to tighter regulation of sales and operation, which would be a burden for the mutual fund industry. Nevertheless the question remains, why do some in the industry warn of a potential market collapse and request more inspections?

Two reasons can be considered. First, large players in the mutual fund industry use this discussion to attack new entrants, including smaller and medium-size funds and commercial banks. Large players, such as Fidelity, Merrill Lynch, and Vanguard, are confident that their methods of sales and operation are appropriate under current law. They think that extended inspections by regulators would keep the image of the industry clean and drive out smaller and medium-size funds, which have greater potential for intentional or unintentional wrongdoing because of fewer resources.[24]

Commercial banks too are the targets of these large players. In November 1993, an SEC survey reported that as many as two-thirds of investors purchasing shares of money market funds at their banks wrongly believed those funds are federally insured. SEC chairman Arthur Levitt said that the lack of disclosure about the riskiness of mutual fund investments is a clear and present danger and called for at least two remedial actions: a physical separation of bank

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[22]Harverson, "The Feeling's Mutual," 16.

[23]Wayne, "In Mutual Funds, Causing Concerns," D4.

[24]Ibid.

facilities that accept deposits from those selling mutual funds and a ban on banks selling funds with names similar to their own.[25]

The second reason for warning of potential market collapse is that the question of whether mutual funds have the potential to bring about such a market collapse is similar to the question of whether stock prices will rise or fall in the next few months. If analysts respond pessimistically, investors will hesitate to buy mutual funds or stocks, but if prices drop in spite of optimistic forecasts, customers will no longer trust the analysts. Therefore, the answer varies from person to person.

5.3.2 Have Commercial Papers Increased Bankruptcies?

Though commercial papers are usually issued to finance needs for short-term funds, some nonfinancial firms issue them to invest in real estate or to purchase inventories or securities that they will hold for a long time. As the term of commercial paper rarely exceeds one year, those companies need to issue new commercial papers when they redeem existing ones.

Companies can finance their needs for long-term funds by rolling over short-term loans from commercial banks continually, but commercial paper issuers, with the expansion of their market, now can raise funds at lower cost than commercial bank loans, improving the flexibility of amount and maturity significantly. Attracted by these features, today most large firms raise their short-term funds through commercial papers rather than commercial bank loans.

The problem for commercial papers occurs when the credit ratings of issuers are downgraded or the issuers' financial conditions worsen. Because investors have no particular relationship to the issuer, they have no reason to support an issuer in trouble and will only try to withdraw their investment. Many investors in pension funds and mutual funds voluntarily restrict short-term investments to only those with the highest credit ratings from both Moody's and Standard & Poor's. They often stop purchasing commercial papers if they hear even the slightest bad rumor about the issuer.

In contrast, commercial banks usually do not cut credit quickly when borrowers are in difficulty. Instead, they sometimes support such borrowers by extending the maturity of the loan or by reducing the interest rate.

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[25]Christi Harlan, "Most Holders of Money-Market Funds Have Wrong Ideas on Bank Insurance," *Wall Street Journal*, Nov. 11, 1993, A4.

Some recent large bankruptcies started with failures in commercial papers roll-overs. Drexel Burnham Lambert expanded its business chiefly through underwriting and market making of so-called junk bonds. The company created the boom in LBOs in the 1980s and grew into one of Wall Street's top investment banks. Its fall began with the departure late in 1988 of Michael R. Milken, the king of junk bonds, following his indictment for securities fraud. Since then, Drexel's reputation has fallen and its marketshare declined. Its descent had a bad impact on the junk bond market, and in the downward spiral the assets it held were devaluated. In December 1989, Standard & Poor's downgraded Drexel's debt rating, further casting doubt for investors on its financial position. In February 1990, it could no longer roll over its commercial paper and filed for Chapter 11 bankruptcy reorganization in federal court in New York.[26]

Olympia & York, a Canadian real estate developer, grew into the world's biggest private landlord through successful development and acquisition of real estate in Canada and the United States. The worldwide slump in the real estate market and Olympia & York's large investment in the London Canary Wharf project made investors skeptical about the company's financial soundness. In 1992, like Drexel, it came to a crisis when Canadian investors refused to accept its new commercial paper while existing ones matured, and the company was compelled to request shelter from bankruptcy court in May.[27]

Both Drexel and Olympia & York might have survived without filing for bankruptcy if their relationships with commercial banks had been closer and if they had not depended on commercial paper. Although regulating the amount of commercial paper a company issues is unrealistic, understanding that excessive dependence on commercial papers might make a company unstable may help companies to recognize the importance of a relationship with commercial banks.

Some experts on financial services argue that continued lending by commercial banks to troubled borrowers is not beneficial either to the borrower or the economy. According to *The Economist*,

> Olympia & York is not in trouble because investors pulled the plug, still less because it kept its cost of borrowing down. It is in trouble because it misjudged its market and borrowed too much. Once those mistakes had been made, what mattered was to expose them promptly so that they could be remedied. Olympia & York suggests that securities markets can spot such mistakes faster than banks. When investors

[26]Judith H. Dobrzynski, Leah J. Nathans, John Meehan, and Eric Schine, "After Drexel," *Business Week*, Feb. 26, 1990, 37-40.

[27]"Bonds, not Banks," *The Economist*, May 23, 1992, 17.

> turned skeptical, most bankers were still hoping the company's assurances of good health were true.[28]

Reckless support based only on a long relationship between a bank and a troubled borrower increases the borrower's debt and damages both borrower and lender. Many companies, however, have recovered from a crisis through the support of commercial banks. Reorganization under bankruptcy court consumes time and money, and a company can obtain only a small amount of money through compulsory sales of assets after declaring bankruptcy. Out-of-court restructuring often rewards both borrowers and lenders. To provide urgently needed finance to a troubled company and to lead that company in the right direction is difficult, but commercial banks can demonstrate their own importance to the economy by undertaking a task that investors in commercial paper can never fulfill.

5.3.3 Does Disintermediation Bring New Risks to the Economy?

"I think that banks play a fundamentally important role in society that is less well filled by others," says Comptroller of the Currency Eugene Ludwig. "I see a decline in the banking system as a shifting of risk—rather than an elimination of risk—to the public from the government."[29] In an era when only high-credit companies could issue securities in capital markets and bank deposits had a dominant share of all financial assets, the credit risks of corporations were taken on exclusively by commercial banks. Because bank deposits are insured by the government, relatively small depositors are not affected by the deterioration of assets at commercial banks.

With the increasing participation of a variety of issuers in the capital markets, it is now no longer rare for institutional and individual bondholders to suffer credit losses through bond defaults. The junk bond boom in the 1980s, which was followed by an increase in defaults and a market collapse, invited significant losses at many S&Ls and insurance companies. With the retreat of S&Ls and insurance companies from the junk bond market under regulatory pressure, mutual funds became the largest purchasers.

> Mutual funds now own as much as 40% of all junk bonds outstanding since scooping up most of the $90 billion or so in public and privately placed low-grade debt offered since 1992.... Mutual fund investors are lending to companies that banks shun. Large funds such as Putnam High Yield Trust ($3.2 billion in assets), Prudential High-Yield ($3.6 billion) and Kemper ($3 billion in two funds) frequently buy $50

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[28]Ibid.

[29]Kenneth H. Bacon, "Banks' Declining Role in Economy Worries Fed, May Hurt Firms," *Wall Street Journal*, July 9, 1993, A1.

> million chunks, far above the lending limit for all but the largest banks.[30]

Unlike federally insured bank deposits, if junk bonds held by a mutual fund default the credit loss is directly transferred to the fund' shareholders.

With the increasing diversification of financial assets held by companies and individuals, market risks have spread to a broad range of investors. Principal and interest rates are guaranteed for bank deposits, but the values of stocks and bonds fluctuate daily. Financial derivatives involve complicated market risks that even professional investors can mismanage. Institutional and individual investors are directly exposed to those risks when they deal in stocks, bonds, and derivatives and indirectly when they invest in mutual funds and pension funds that hold risky assets. "Many Americans are far more involved in derivatives than they realize. Their pension funds, mutual funds and insurance companies are knee-deep in the market and wading in further."[31]

Interest-only strips (IOs) are typical of the financial products that recently inflicted losses on many investors. They give holders only the interest portion on a group of mortgages. More volatile than regular mortgage-backed securities, IOs offer returns as much as twice those of regular ones. Their value began to collapse in 1993, when refinancing of residential mortgages peaked. Because holders of IOs can receive only the interest portion, they obtain no payment when mortgages are prepaid. In October 1993, holders of Hyperion 1999 Term Trust, Inc., a publicly traded closed-end bond fund partly invested in IOs, filed a lawsuit seeking class-action status after the price of shares dropped 30 percent and the fund's dividend was cut to 52 cents from 80 cents. The suit charged that investors in the fund were misled by the fund's official sales document, which stressed the high quality of the credit.[32]

Some regulatory agencies are trying to restrict the sales or purchase of "risky" financial products. In September 1993, at a national conference of state insurance commissioners held in Boston, tighter regulations were proposed on the way insurance companies invest their money. In addition to setting limits on foreign bonds and real estate (**Table 5-2**), the proposal would outlaw speculative investments in derivatives, although these could be used for hedging. It also would prohibit insurers from making nonamortizing loans that have more than

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[30]Laura Jereski, "Risks in Junk Bonds Rise as Mutual Funds Play a Growing Role," *Wall Street Journal*, Oct. 1, 1993, A1.

[31]Barbara Donnelly Granito and Craig Torres, "Many Americans Run Hidden Financial Risk From 'Derivatives,'" *Wall Street Journal*, Aug. 10, 1993, A1.

[32]Laura Jereski and Thomas T. Vogel, Jr., "Suit Attacks Mortgages' Safety Level," *Wall Street Journal*, Oct. 25, 1993, C1. Also see Susan Pulliam, "Firms Face Big Losses on IO Investments," *Wall Street Journal*, Oct. 28, 1993, C23.

Table 5-2

Proposed Investment Limits: Maximum Investments in Various Asset Categories under the Model Investment Law

	Life Insurers	Property/Casualty Insurers
U.S. Government Bonds	100%	100%
Stocks	10	5
Commercial Mortgages	30	10
Investment Real Estate	15	5
Foreign Bonds	10	15
Futures or Options	1	1

Source: National Association of Insurance Commissioners. Quoted in Greg Steinmetz, "Regulators Seek Tighter Rules on Insurers' Investments," *Wall Street Journal*, Oct. 25, 1993, B4.

a 60 percent loan-to-value ratio.[33] Just as commercial banks claim that strict investigation of loan quality discourages lending to small businesses, insurance companies insist that tight regulation would later harm consumers as well as the economy. According to industry officials, "the proposal is so restrictive they could no longer earn competitive interest rates on their investment, which would mean more expensive insurance policies and lower dividends for policyholders. The proposal would also hurt the economy by freezing insurance industry capital out of the real estate business and other industries."[34]

In 1993, the state auditor in Ohio filed a lawsuit seeking strict restrictions on the sales and purchase of IOs after the disclosure of big losses by local governments there in trading securities. In October, Ohio's attorney general determined that the mortgage-backed securities issued by the Federal National Mortgage Association were unsuitable investments for the operating funds of many municipalities and school districts. The state auditor is expected to ask the attorney general to declare investments in IOs illegal under Ohio's current investment guidelines. According to Rod Ridge, chairman of the investment policy committee of the

[33]Greg Steinmetz, "Regulators Seek Tighter Rules on Insurers' Investments," *Wall Street Journal*, Oct. 25, 1993, B4.

[34]Ibid.

National Municipal Treasures Association, other states are likely to follow Ohio's expected ban on IO investments.[35]

Do such restrictions always lead investors in the right direction and contribute to the stability of the economy as a whole? As discussed in **Chapter Six**, until recently Japanese companies that wanted to issue unsecured bonds in domestic capital markets were subject to strict qualifications determined by the Ministry of Finance. As a result, unlike U.S. corporations, most corporations in Japan could not enjoy access to a large number of investors through capital markets and remain dependent on borrowing from commercial banks. For investors seeking fixed-rate assets, choices were limited to bonds issued by a few high-quality borrowers such as the government, electric power companies, or telephone companies.

Japanese stock investment trusts (a financial product similar to U.S. stock mutual funds) also are subject to regulation, including stringent restrictions on the use of financial derivatives such as futures and options. The restriction on derivatives is considered by some economists and leaders in the securities industry as the main reason almost all Japanese stock investment trusts have recorded a poor performance during the stock market decline since 1990. They say that if active use of stock futures and options had been allowed, at least several stock investment trusts might have produced rather high returns in spite of that decline (see section **6.2.1**).

In comparison with the liberalized capital markets in the United States, the rules in Japan may seem out-dated, but they were based on the same idea as the regulations used by insurance regulators or state auditors in the United States, that regulations are intended to protect investors by restricting free sales and purchase of securities. Therefore, through restrictions on the sales or purchase of "risky" financial products, investors may be losers in one circumstance, while the same regulations may lead them in the right direction under normal conditions, when stock and bond prices are rather stable or growing gradually. Mutual fund companies and investment banks that emphasize the sales of securities that involve such exotic products as IOs would also be losers under the proposed new regulations. Even if regulations were to prohibit transactions of IOs, there is no assurance that the money would return to commercial bank deposits because many other alternatives exist. With the tight regulatory qualifications on issuers in Japan, commercial banks are winners, because most firms are restrained from borrowing from capital markets.

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[35]Laura Jereski, "Ohio Case Signals Backlash Against Exotic Mortgages," *Wall Street Journal*, Nov. 11, 1993, C1.

5.3.4 Does Nonbank Expansion Diminish the Effect of the Fed's Monetary Policy?

In July 1993 Federal Reserve Board Chairman Alan Greenspan testified before Congress that "M2 has been downgraded as a reliable indicator of financial conditions in the economy."[36] The link between money supply, economic growth, and interest rates broke in 1991, when rates started dropping and people began pulling money out of bank CDs and savings deposits (part of M2) to hunt for higher returns in mutual funds (not counted as part of the money supply).[37] Carnegie-Mellon professor of economics Allan Meltzer agreed that M2 failed as a policy guide but claims that another measure of money, the monetary base, is useful. The base includes all the reserves held by banks as well as currency in circulation.[38]

According to David Ramsour, senior vice president and chief economist of the Bank of Hawaii, other monetary tools also have been weakened:

> One is the Fed's ability to control the rate of credit creation. The development of financial markets, which has allowed greater participation of new types of institutions, has resulted in a rapid decline of bank's role as suppliers of credit.... The tools the Fed uses in implementing monetary policy range from infrequent shifts in reserve requirements of daily open market operations to changes in the discount and Fed funds rates. While all of these could be employed without a banking system, they by and large have been designed with the banking system in mind.[39]

Up to now, the issue seems to be monetary policy or economics, rather than a dispute among financial services industries. In the future, the assertion that expansion of nonbanks loosens the effect of monetary policy and therefore makes the economy unstable may be used by commercial banks when they require legislation favoring their interests.

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[36]Statement made before the Subcommittee on Economic Growth and Credit Formation of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, July 20, 1993, Federal Reserve Bulletin, September 1993, 852.

[37]"The Fed Drops a Yardstick," *Fortune*, Aug. 23, 1993, 22.

[38]Ibid.

[39]David L. Ramsour, "Nonbank Inroads Loosen Fed's Grip," *ABA Banking Journal*, September 1993, 20.

5.4 Fair Competition among Financial Services Industries

5.4.1 Disadvantages of Commercial Banks

As discussed in **Chapter Three**, mutual funds and pension funds are typical financial products that expanded through advanced information technology. They have provided investors with limited funds the opportunity to purchase a portfolio of diversified assets and to be served by professional fund managers. Attracted by these features, individual investors have shifted a large portion of their assets from direct holding of securities, life insurance, or bank deposits to mutual funds and pension funds.

> Reflecting the changes in household portfolios, the investment banking industry also shifted its emphasis away from the individual investor toward providing services for pension and mutual funds. Many firms discovered new profit opportunities in providing trading expertise and risk-management products and advice.... The investment banking industry has been able to adapt to these changes because of the relative absence of regulatory restrictions preventing the development of new lines of business.[40]

Life insurance companies also have been allowed to participate in the business of pension fund and mutual fund, though the limitation on holding corporate stocks was an obstacle for them. "Management of pension fund assets has now replaced sale of life insurance as the principal business of the life insurance industry.... Many larger life insurance companies have sponsored mutual funds and some have purchased investment banking firms."[41]

In contrast, commercial banks have been negatively affected by the growth of pension funds and mutual funds, because their business turf has been strictly regulated. A significant amount of funds has been shifted from bank deposits to money market mutual funds. Pension funds and mutual funds have also supported the growth of corporate bonds and commercial papers, which compete with commercial bank loans.

Although the commercial banking industry has had difficulty expanding its business area and adjusting to the new financial products, there were few restrictions on other financial firms entering the commercial banking business. As **Table 5-3** shows, in the 1990s commercial banks face challenges from various types of financial firms in every area of service.

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[40]Gordon H. Sellon, Jr., "Changes in Financial Intermediation: The Role of Pension and Mutual Funds," *Economic Review*, Federal Reserve Bank of Kansas City, Third Quarter 1992, 61-62.

[41]Ibid., 63.

Table 5-3

Financial Services Industry in 1950 and 1990

1950

Institution	Function: Payment Services	Savings Products	Fiduciary Services	Lending: Business	Lending: Consumer	Underwriting/ Issuance of: Equity	Underwriting/ Issuance of: Debt	Insurance and Risk Management Products
Insured depository institutions	X	X	X	X	X			
Insurance companies		X		X*				X
Finance companies				X*	X			
Securities firms		X	X			X	X	
Pension funds		X						
Mutual funds		X						

*Minor involvement.

1990

Institution	Function: Payment Services	Savings Products	Fiduciary Services	Lending: Business	Lending: Consumer	Underwriting/ Issuance of: Equity	Underwriting/ Issuance of: Debt	Insurance and Risk Management Products
Insured depository institutions	X	X	X	X	X	X*	X*	X*
Insurance companies	X	X	X	X	X			X
Finance companies	X	X	X	X	X	X	X	X
Securities firms	X	X	X	X	X	X	X	X
Pension funds		X	X					X
Mutual funds	X	X	X					X
Diversified financial firms	X	X	X	X	X	X	X	X
Specialist firms	X	X	X	X	X	X	X	X

*Minor involvement.

Source: Quoted in Edward E. Farash, "Banking's Critical Crossroads," *The Bankers Magazine* (March–April 1993), pp. 22-23.

Nonbank competitors have some regulatory advantages for operating their business, because most of them are not regulated by restrictions on nationwide branching, CRA responsibilities, and minimum capital requirements. **Table 5-4** lists nonbank competitors and their regulatory advantages.

Table 5-4

Advantages of Nonbank Competitors

Mutual Funds

Mutual funds have toll-free phone numbers and sales representatives all over the country; bricks and mortar are unimportant to them. Commercial banks have bricks and mortar, and a host of laws and regulations come into play if a commercial bank attempts to close even a single branch. Mutual funds have no Community Reinvestment Act responsibilities, no government-dictated capital requirements, no annual examinations by federal examiners, and no Bank Holding Companies Act restrictions on the activities of any affiliates.

Credit Unions

Credit unions pay taxes and generally no rent, operate under much less stringent regulations than a typical commercial bank or bank holding company, and pay more for deposits and charge less for loans than a neighborhood bank.

Investment Banks and Securities Firms

These businesses operate nationwide, thereby maximizing capital and marketing synergies (which commercial banks cannot do). The capital rules under which they operate do not include their parent or affiliated companies, and the direct capital rules are no more onerous than those facing commercial banks in the business. No consumer laws and regulations cover these businesses, and there are no interlocking director rules beyond the modest ones of the antitrust laws, no Bank Holding Companies Act restrictions, and no lengthy delays that occur when they want to enter a new business or establish, eliminate, or move an office.

Government-Sponsored Entities

These have a government charter, the implicit guarantee of the U.S. government, capital levels acceptable to the government that any banker would relish operating under, tax advantages, and a resulting near monopoly on certain lines of profitable business.

Other Competitors

Commercial banks also compete with (1) insurance companies that have no federal regulation at all; (2) public utilities that operate under statutes that guarantee a profitable rate of return; and (3) commercial firms whose only venture into financial services is to gather deposits at a lower rate of interest than the market would otherwise demand.

Source: Robert E. Barnett, "Why Banks Can't Compete," *The Bankers Magazine*, March-April 1993, 62-63.

5.4.2 Entry of Commercial Banks into New Business

At the same time that many nonbank firms have made inroads into traditional commercial banking services, such as lending and deposit taking, these services have become less profitable, and the commercial banking industry has increasingly needed regulation lifted on the services it can offer.

As a result, since the late 1980s commercial banks have obtained broader authority to expand into financial services other than their traditional business. In 1993 about 3,500 commercial banks offered mutual funds, and in 1992 a third of all mutual funds were sold through them. About half the states permit state-chartered banks to sell most insurance products. Since J.P. Morgan was allowed to underwrite and sell stocks in 1990, a few commercial banks have gained the same approval from the Federal Reserve Board. According to Eugene A. Ludwig, new bank products and services should be presumed permissible if they satisfy two tests: first, they must not cause material safety or soundness problems; and, second, adding the new product or service should, on balance, benefit consumers of financial services.[42]

5.4.3 Opposition by Nonbank Financial Firms

Not surprisingly, the entry of commercial banks into new business has not been welcomed by other players in the financial services industry, whose opposition is most frequently phrased in terms of "consumer benefit" and "fair competition."

Insurance agents, most of whom work on commission, worry that letting banks into the insurance business threatens their livelihood. "We can compete with anybody, but we are concerned about unfair competition," said Paul Equale, senior vice president of the Independent Insurance Agents of America, a lobbying group. He warned that banks might take unfair advantage of customers, such as forcing a loan applicant to buy insurance as a condition of getting a loan.[43]

In December 1993, a District Court judge in Jacksonville, Florida, rejected Barnett Bank's assertion in a lawsuit that federal statutes should override a state law prohibiting bank-holding companies from selling insurance. "Tom Gallagher, Florida's treasurer and insurance commissioner, hailed the ruling as a 'victory for consumers.' The Florida Department of

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[42]Remarks by Ludwig before the Merrill Lynch Financial Services Conference, Sept. 13, 1993, 4.

[43]Steven Lipin and Greg Steinmetz, "Banks Push Insurance; Public May Profit," *Wall Street Journal*, Oct. 5, 1993, B6.

Insurance, the defendant in the case, oppose[d] the efforts of banks to sell insurance primarily for fear of coercion when individuals apply for loans, Mr.Gallagher has said."[44]

In 1992, Morgan Stanley asked federal regulators to investigate several allegations of illegal tying—activities that require a customer seeking a letter of credit from a commercial bank to use the bank's securities subsidiary as an underwriter when the customer issues corporate bonds.

As discussed in sections **5.2.2** and **5.3.1**, the mutual fund and securities industries demand tighter regulation of sales of mutual funds by commercial banks on the pretext of protecting investors. Objecting to the entry of commercial banks into the security business, Marc Lackritz, executive vice president of the Securities Industry Association, said,

> We must avoid any government-conferred advantages, helping any market parti[cipant] to compete unfairly. This concern is especially important now as we ponder how much U.S. taxpayers will have to pay for the savings and loan debacle. The ability to accept federally insured deposits is a valuable franchise and should not be used as a means to obtain cheap funding for risky and speculative activities.[45]

5.4.4 Regulatory Fragmentation

Financial services regulation is divided among many agencies, with each responsible for a particular sector. This division makes regulators champions of their own sector, frequently feuding with other industry regulators to protect the interests of the particular sector.[46] While the Comptroller of the Currency supports the entry of commercial banks into insurance sales and other business (see sections **5.2.3** and **5.4.2**), the SEC tries to impose tighter restriction on mutual fund sales by commercial banks (see section **5.3.1**). Regulatory fragmentation in the financial services industry means that cross-sectoral competitive conflicts are more likely to be resolved by courts and Congress rather by a regulatory body. Regulatory fragmentation is also reflected in the divided jurisdiction of Congressional committees.[47]

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[44]"Judge Rejects Suit Seeking to Sell Insurance in Florida," *Wall Street Journal*, Dec. 7, 1993, A8.

[45]Hearings before the Committee on Banking, Finance, and Urban Affairs, Aug. 1, 1990.

[46]John F. McLaughlin and Thomas E. McManus, *Competitive Uses of Regulation in the Financial Services Arena* (Cambridge, Mass.: Program on Information Resources Policy, Harvard University, July 1994, I-94-1), 78.

[47]Ibid., 79.

5.4.5 Advantages of Commercial Banks

Opposition to the expansion of the business territory of commercial banks indicates that their branch and ATM networks and long-established relationship with customers are still considered great threats to competitors. Paul F. Walsh, chairman of the Banc One Diversified Services Corporation, a holding company for the corporation's nonbank affiliates, told *The Bankers Magazine*,

> The single greatest advantage that banks have is the relationship with the customer. This is clearly true on the retail side of the business, as well as with small and middle-market companies that look to their bank as their primary financial institution.... The competitive test will be how well banks are able to offer a seamless delivery of products and services that cut across the spectrum of customer needs, going beyond the point of simply providing credit or depository services.[48]

When commercial banks enter the new business, they often use their network or strong relationship with customers established through their core business.

> [Commercial] banks have been adding mutual fund transactions to the list of functions on their ATMs. In addition to making a deposit or checking a balance, investors now can buy shares in their existing mutual fund accounts, make switches among funds and redeem shares by transfers to another account at the bank.[49]

> [Citibank] is taking advantage of its giant credit card unit, which has 19 million accounts, to cross sell insurance products to card customers through mail and telemarketing.[50]

5.4.6 Winners and Losers

If the business territory of commercial banks is allowed to expand, who are the possible winners and losers?

Although the controversy over business territory has been chiefly between the commercial banking industry and other financial services industries, deregulation of the products offered by commercial banks affects each financial firm differently, even within the same industry.

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[48] "A Midwest Superregional Creates Nonbank: An Interview with Paul F. Walsh," *The Bankers Magazine* (March-April 1993), 7-8.

[49] Mary Romano, "Mutual Fund Sales Growing at Bank ATMs," *Wall Street Journal*, Aug. 16, 1993.

[50] Lipin and Steinmetz, "Banks Push...," B1.

Some commercial banks, such as J.P. Morgan and Bankers Trust, made a stable profit from trading securities for its own account, while some investment banks reported large losses in securities trading. However, as Marc Lackritz warned, the securities business may inflict large losses on commercial banks that are not very skilled. Commercial banks without the resources to extend their business to new areas may be disadvantaged even in traditional business when competing with those able to diversify revenue sources and strengthen their financial position.

While the entry of commercial banks into insurance sales threatens the profit of insurance agencies that earn most of theirs from commissions, it benefits those that write policies themselves because they can have new outlets through which to sell products. The same is true of the mutual fund sales. Some mutual fund groups are expanding their sales channels by cooperating with commercial banks.

The entry of nonbank firms, along with the deregulation of interest rates and services, has accelerated competition in the commercial banking business. The spread between high- and low- performing commercial banks has widened, and some commercial banks that could not keep up with competitors have left the industry either through merger or liquidation. If the business territory of commercial banks is allowed to expand further, the severe competition such as now exists in lending and fund gathering will be extended to securities underwriting and insurance sales.

With more financial firms breaking through the traditional boundaries among financial industries, the identity of each industry will be weakened. Some industries, such as the mutual fund industry, "may cease to exist as an industry and may simply become a class of products sold by a different types of institutions."[51]

The ultimate competition after the boundaries among financial industries have broken down will not occur in the form of industry versus industry but firm versus firm. Even if an industry prospers, some within it may fail. Although deregulation will squeeze the profits of financial firms by severe competition, it will also offer opportunities to explore new business. Only firms that can adapt to the changes will survive.

Whether consumers can benefit from the expansion of services provided by commercial banks depends on perspective, that of the commercial banking industry and those of other financial industries. The commercial banking industry asserts that the individual consumers of financial services will benefit because they will receive a greater variety of services by just

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[51]Erik R. Sirri and Peter Tufano, "Competition and Change in the Mutual Fund Industry," *Financial Services: Perspective and Challenges*, edited by Samuel L. Hayes III (Cambridge, Mass.: Harvard Business School Press, 1993), 213.

dropping in at a bank branch and because commissions on insurance and securities trading will be made less expensive through the competition.

In contrast, insurance and securities industries contend that the entry of commercial banks into insurance and securities sales will lead to the illegal tying of commercial banking to those businesses and will harm the consumer benefit. According to the mutual fund and securities industries, sales of mutual funds by commercial banks mislead investors into believing that the funds are insured by the government as bank deposits are. Marc Lackritz warned that given the risks in the securities business, commercial banks' entries into speculative activities may increase bank failures, for which "tax payers will have to pay."[52]

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[52]See note 45.

Chapter Six

Competition and Regulation in Japan

6.1 General Characteristics of Japanese Financial Regulations

A study by Thomas F. Cargill, professor of economics at the University of Nevada, and Shoichi Royama, professor of economics at Osaka University, showed that "the financial reform process in Japan differs from the U.S. experience in three important ways: (*i*) the process has been administratively directed and incremental; (*ii*) the process has been relatively smooth and lacking of financial disruptions; and (*iii*) the process has been characterized by regulatory rather than market innovations and lacks an intense regulatory-market conflict."[1]

Kikuo Iwata, professor of economics at Sophia University in Tokyo, criticized Japanese financial regulators specifically for three features: (*i*) they are devoted to coordinating the interests of financial industries and do not attach importance to the interests of consumers; (*ii*) they regulate or lead the financial institutions by administrative guidance, not legislation; and (*iii*) they do not believe in the effectiveness of the market mechanism.[2]

According to both studies, Japanese financial regulation is characterized by the administrative guidance by Ministry of Finance. Unlike in the United States, where there are multiple regulators even for the commercial banking industry, in Japan the Ministry of Finance is the sole regulator over commercial banks, security houses, and insurance companies. Nonfinancial institutions also must obey the Ministry's guidelines when they issue equities, corporate bonds, and commercial papers.

In the United States, financial products developed through the use of advanced information technology played an important role in promoting liberalization of the financial system and in accelerating competition among different types of financial institutions: the regulations governing deposit interest rates were rendered ineffective by the emergence of money market mutual funds; the development of corporate bond and commercial paper markets provided nonbank financial firms with low-cost funding sources with which to compete with commercial banks; and to compensate for the entry of nonbank firms into the

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[1]Thomas F. Cargill, "An Overview of Financial Change in Japan and the United States," *Networks and Society: Proceedings of the First IPTP Conference*, edited by Yasuhiko Oishi and Masaaki Komai (Institute for Posts and Telecommunications Policy and Ministry of Posts and Telecommunications, 1991), 184. Also, Thomas F. Cargill and Shoichi Royama, "The Transition of Finance in Japan and the United States: A Comparative Perspective" (Hoover Institution, 1988), 167-199.

[2]Kikuo Iwata, "Keizai Kyoshitsu: Nihon no risutora—watashino sekkei" [Seminar in Economics: Restructuring of Japan—Plan for Future], Nihon Keizai Shimbun, Aug. 9, 1993.

commercial banking business, regulators approved the expansion of the territory of commercial banks to include the securities and insurance business.

In Japan, however, offering financial products that would directly compete with those of commercial banks has been strictly regulated by administrative guidance. Because of the sole regulator system and the force of administrative guidance, challenging regulatory authority or by-passing regulations has been very difficult. As a result, as Cargill and Royama showed, the role of innovative financial products developed through advanced information technology in promoting liberalization of financial system has been much smaller there than in the United States.

According to Kikuo Iwata, the Ministry of Finance tends to coordinate the interests of different types of financial institutions rather than allow the institutions to compete in the free market. In other words, the Ministry has restrained the liberalization of financial services on the grounds of stability of the financial system, fair competition among financial service industries, and protection of individuals and small businesses. As a result, Japan has substantially fallen behind the United States in liberalization of deposit interest, introduction of new financial products such as money market mutual funds, development of the corporate bond market, and cross-entries among different types of financial institutions. Although Japanese financial institutions have not experienced the kind of disruption that occurred in the U.S. S&L industry, in the 1990s many recognize that Japanese users of financial services do not enjoy the variety of investments and fund raising methods U.S. users have obtained through heavy competition among financial service providers.

Yet the situation in Japan is gradually changing. Some major restrictions on corporate bonds, commercial papers, and investment trusts (Japanese-type mutual funds) have been lifted since the late 1980s. In 1993, commercial banks entered the securities business through their subsidiaries. Full liberalization of deposit interest rates is scheduled for 1994.

This chapter discusses the forces that have restrained or promoted competition among Japanese financial institutions and how regulators and financial institutions behaved under the resulting conditions. The analysis covers three areas: competition in fund gathering; competition in lending; and the securities business of commercial banks.

6.2 Competition in Fund Gathering

6.2.1 Regulations of Investment Trusts

Investment trusts are Japanese financial products similar to U.S. mutual funds. They are invested in diversified financial assets, such as equities, government bonds, and certificates of

deposit, and then distribute returns to holders of the funds. The outstanding balance of investment trusts is still small in comparison with that of bank deposits, although bond investment trusts have shown remarkable growth since 1992. **Table 6-1** shows the financial assets portfolios held by nonfinancial corporations and individuals in 1980 and 1992, and **Table 6-2** shows the balance of investment trusts since 1982.

Table 6-1

Composition of Major Financial Assets (As of Year-End, in ¥ Trillions)

Corporate Business Sector

	1980		1992	
Demand Deposits	31	(34%)	50	(18%)
Time Deposits	46	(50%)	113	(40%)
Certificate of Deposits	2	(2%)	8	(3%)
Securities	13	(14%)	107	(39%)
Total	92	(100%)	278	(100%)

Personal Sector

	1980		1992	
Cash Currency	15	(5%)	33	(3%)
Demand Deposits	28	(9%)	61	(6%)
Time Deposits	178	(55%)	469	(46%)
Trusts	21	(6%)	75	(7%)
Insurance	45	(14%)	234	(23%)
Securities*	38	(12%)	143	(14%)
Total	325	(100%)	1,016	(100%)

Note: Securities Investment Trusts are included in "Securities."

Source: Bank of Japan, "Flow of Funds Accounts," *Economic Statistics Monthly*, October 1982, 32, and October 1993, 163.

In imitation of U.S. money market mutual funds, medium-term government bond (Chukoku) funds, invested mostly in medium-term government bonds, were introduced in Japan in January 1980. Having attracted individual investors with a promise of higher returns than bank deposits, Chukoku funds grew to a balance of 6 trillion yen ($55 billion) by the end of 1987 (**Table 6-3**). Because the Ministry of Finance required that interest rates on these funds could not substantially exceed those of bank deposits, commercial banks have been able to catch up with those rates by introducing new types of time deposits with higher interest

Table 6-2

Outstanding Amount of Investment Trusts
(As of Year-End, in ¥ Billions)

Year	Stock Investment Trusts	Bond Investment Trusts	Total
1982	4,542	4,403	8,945
1983	5,456	7,744	13,200
1984	7,481	9,982	17,463
1985	10,031	9,246	19,277
1986	17,763	12,562	30,325
1987	31,413	12,340	43,753
1988	37,768	13,696	51,463
1989	41,354	12,952	54,306
1990	41,569	10,776	52,346
1991	34,206	12,575	46,781
1992	29,152	21,821	50,972
1993.10	25,517	28,732	54,249

Source: Investment Trusts Association. Quoted in Nomura Research Institute, "Principals of Investment Trusts," *Quarterly Economic Review*, August 1987, 64, and February 1994, 86.

rates than the old ones. Although bank time deposits and direct holding of stocks have grown substantially since 1987, the balance of Chukoku funds decreased to 3 trillion yen at the end of 1992.

Money management funds, invested mostly in the short-term money market, were introduced in May 1992. In Japan, however, several restrictions on money management funds have been imposed by Ministry of Finance, rather than through the limits of technology, while in the United States restrictions such as minimum purchase amount, minimum holding period, and same-day withdrawal of money market funds have been lifted with improvements in the technology to manage these processes.

For example, according to the Ministry, the minimum purchase (which applies also to additional purchases) is 500,000 yen ($4,500), the minimum period after which money can be withdrawn without penalty is thirty days, and investors wishing to withdraw money cannot do so until the next day. These regulations inhibited direct competition between money management funds and bank deposits and protected the interests of commercial banks.

Table 6-3

Outstanding Amount of Medium-Term Government Bond (Chukoku) Funds (As of Year-End, in ¥ Billions)

1983	4,227
1984	5,110
1985	4,012
1986	5,521
1987	5,989
1988	5,764
1989	5,677
1990	4,140
1991	3,084
1992	3,086
1993 Aug.	3,862

Sources: Bank of Japan, "Sales and Repurchases to Investment Trusts (Principal Base)," *Economic Statistics Annual*, 1991, 203, and *Economic Statistics Monthly*, October 1993, 148.

With fewer restrictions on the interest rates of money management funds (as of November 1993, the return on one-year money management funds is about 1 percent higher than on bank deposits for the same period), these funds attracted more investors than Chukoku funds. The balance of money management funds reached 11 trillion yen ($100 billion) in the year and a half since sales started.

Given the favorable beginning for money market mutual funds, security houses believed sales of the funds would increase if the Ministry of Finance would loosen the rules, and they strongly requested further deregulation of money management funds. In reply, the Ministry is reportedly considering reducing the minimum purchase amount to 100,000 yen, from 500,000 yen, and the minimum holding period to ten days, from the current thirty days.[3] These reductions will accelerate competition between bank deposits and money management funds and broaden the choices for depositors. Strong opposition to the changes is expected from commercial banks.

The Ministry of Finance administers financial regulation through four Bureaus: the Banking Bureau, which controls commercial banks; Securities Bureau; the Insurance Bureau;

[3]"Saitei azukeire-gaku, MMF ju-man-yen ni" [Minimum Purchase Amount of MMF (money market funds) Reduced to 100,000 yen], Nihon Keizai Shimbun, Nov. 29, 1993, 1.

and the International Finance Bureau. Each bureau regulates the appropriate industry and represents its interests. The demands of the securities industry are usually channeled through the Securities Bureau and negotiated between the Securities Bureau and the other bureaus that represent the other financial industries. This system comes into use when one industry group tries to challenge regulations that protect another or seeks to maintain regulations that protect itself. The change in the rules governing money management funds provides an example of the system functioning to liberalize regulations.

The performance of stock investment trusts since 1990, however, has been disastrous. Stock funds that failed to reach par value amounted to 10 trillion yen in October 1993 (about 40 percent of the total balance).[4] The balance of stock investment trusts decreased to 26 trillion yen ($230 billion) in October 1993, from 42 trillion yen ($380 billion) at the end of 1990 (see **Table 6-2**).

Yoshiro Miwa, professor of economics at Tokyo University, argued that aside from the depressed performance of the Japanese stock market since 1990, there are four reasons for the poor performance of Japanese stock investment trusts: (*i*) the number of investment trust companies is small (eighteen at the end of 1991) and they have similar investment policies; (*ii*) most of the funds are sold through security houses that are the parents of the investment trust companies, so that information on comparison of the funds is not widely distributed, leading to little competition; (*iii*) as a result of (*ii*) the quality of fund managers is poor, and no system of valuation and rewards has been established; and (*iv*) there are many restrictions on investments of the investment trust companies.[5]

Point (*iv*) is important for U.S. regulators discussing regulations on derivatives and exotic investments, such as IOs, in the 1990s. In addition to needing the approval of the Ministry of Finance, Japanese investment trust companies are subject to the "voluntary rules" of the Investment Trust Association[6] before they can begin sales of new investment trust packages. According to the voluntary rules, (*i*) a company cannot put the money into large-lot time deposits (bank deposits that have minimum deposit requirements but no regulatory ceiling on interest rates), (*ii*) the aggregate balance of domestic commercial papers and domestic certificate of deposits should not exceed 45 percent of total fund balance, and (*iii*) forward and option transactions are prohibited except for hedging. The restrictions on time deposits, commercial papers, and certificates of deposit are required by commercial banks,

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[4]"Toushi-shintaku—Honkaku Kyousou Jidai e Ippo" [Investment Trust—A Step to the Era of Real Competition], Nihon Keizai Shimbun, Dec. 1, 1993, 27.

[5]Yoshiro Miwa, "Kinyu Gyosei Kaikaku" [Reform of Financial Policy], Nihon Keizai Shimbun-sha, 1993, 279-280.

[6]Most "voluntary rules" of Japanese industry groups are based on the guidance of the ministries or created to avoid tighter regulation by them.

which do not want investment trusts to offer a feature similar to bank deposits. The restrictions on forward and option transactions are imposed to protect investors from such "risky" transactions. With the continuing decline of stock prices since 1990, the restrictions on forwards and options have harmed the interests of investors, because most Japanese investment trust companies had no way to make profits and could at most keep the par value.

6.2.2 Factors Affecting the Liberalization of Deposit Interest Rates

As in the United States, ceilings originally were set on Japanese deposit interest rates to protect depositors.[7] Although excessive competition in interest rates was thought to increase the failures of deposit-taking institutions and damage the benefit of depositors, as **Table 6-4** shows since the late 1970s Japanese deposit interest rates have been gradually liberalized, and all regulations on deposit interest rates are scheduled to be lifted June 1994.

In the United States, with the development of innovative financial products such as money market mutual funds, regulations on deposit interest rates, which had protected the profits of commercial banks, turned into obstacles for them in the competition with players from outside the industry. The regulations were lifted at the request of the commercial banking industry itself. What are the major factors in the liberalization of deposit interest rates in Japan?

In an interview with *Kinzai Weekly*, a Japanese financial magazine, Masaaki Tsuchida, director of the Banking Bureau of the Ministry of Finance, said that the purpose of liberalization of deposit interest rates is to contribute to the benefit of depositors by establishing an efficient financial system through competition among financial institutions.[8] Yet an examination of the course of liberalization shows that other factors were more important than the demand of depositors.

Liberalization of deposit interest rates in Japan occurred in two stages.[9]

The first stage occurred, as in the United States, because of competition from outside the commercial banking industry. With expansion of the volume of the government bond issue since 1975, Gen-saki trading—sales of securities with a repurchase agreement or purchase of securities with a resale agreement—became popular among security houses and nonfinancial

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[7]Ryuichiro Tachi, "Kinyu sai-hensei no shiten" [Point of Sight to Restructuring of the Financial System], Toyo Keizai Shimpo Sha, 1985, 61.

[8]"Seido Kaikaku wa Kinyu Sisutemu no Anteika ni Shisuru" [Financial Reform Contributes to the Stability of Financial System], *Kinzai Weekly*, May 4, 1992, 18.

[9]Kyosuke Takase, "Kinyu Henkaku to Kinyu Sai-hensei" [Evolution and Reorganization in Finance], Nihon-Hyoron-sha, 1988, 161.

Table 6-4

Liberalization of Deposit Interest Rates
(Minimum Amount of Deposits with No Interest Rate Ceiling)

Certificates of Deposit	
April 1979	¥500 million
January 1984	¥300 million
April 1985	¥100 million
April 1988	¥50 million
Large-Lots Time Deposits	
October 1985	¥1 billion
April 1986	¥500 million
September 1986	¥300 million
April 1987	¥100 million
April 1988	¥50 million
November 1988	¥30 million
April 1989	¥20 million
October 1989	¥10 million
Money Market Certificates	
April 1985	¥50 million
September 1986	¥30 million
April 1987	¥20 million
October 1987	¥10 million
June 1989	¥3 million
April 1990	¥1 million
April 1991	¥500 thousand
June 1992	No Restriction
Super Time Deposit	
November 1991	¥3 million
June 1993	No Restriction

Source: "Ryudosei Yokin Kinri—Jiyuka e Meisou, Jou [Deposit Interest Rate—Difficult Way to Liberalization, Part 1]," *Nihon Keizai Shimbun*, November 4, 1993, p. 5.

corporations, and short-term funds from nonfinancial corporations, previously deposited exclusively at commercial banks, began to be shifted to the Gen-saki market. To meet the challenge of Gen-saki, in 1979 the commercial banks applied to the Ministry of Finance to introduce Negotiable Certificates of Deposit, the first bank deposits without regulated ceilings on interest rates, and the ministry approved them. No significant rival to bank deposits appeared after the emergence of Gen-saki, halting liberalization of deposit interest rates until the mid-1980s.

The second stage was initiated under pressure from the United States. Since the late 1970s the United States had faced a large trade deficit with Japan, and in 1983 it insisted that the low yen rate in relation to the U.S. dollar was the main cause of the trade imbalance between the two countries. The United States said that delayed liberalization of the Japanese financial system had reduced the yen's liquidity and kept the exchange rate low. In reply to the request for promoting liberalization of the financial system, in 1984 the Ministry of Finance announced a schedule for "liberalization of the Japanese financial system" and "internationalization of the yen." Liberalization of deposit interest rates was resumed in line with this schedule. At this stage, the emergence of new financial products such as medium-term government bond funds and money management funds had become an important factor in encouraging commercial banks to accept the liberalization, although owing to the tight regulations and a relatively low inflation rate in Japan, the impact has been less intense than that of mutual funds in the United States.

6.2.3 Conflict Between Commercial Banks and the Postal Savings System

The Ministry of Finance controls most Japanese financial institutions, with one important exception. The postal savings system, which had a total deposit amounting to 170 trillion yen ($1.5 trillion) at the end of March 1993, is operated by the Ministry of Posts and Telecommunications (MPT). Aside from the ongoing controversy about the existence of the postal savings system, the friction between commercial banks and the postal savings system has increased as the target date (June 1994) nears for full liberalization of deposit interest rates.

The postal savings system has traditionally offered higher interest rates than commercial banks. As of November 1993, the interest rate on its ordinary accounts was 1.32 percent, while the rate on comparable accounts at commercial banks was 0.22 percent.[10] Commercial banks fear that after deregulation high postal interest rates will act as a catalyst to drive up market rates higher and faster than would otherwise be the case.[11] According to officials of a regional bank association, regional banks will lose money equal to a third of their pre-tax profit in fiscal 1993 if their deposit interest rates match those offered by the postal savings system.[12]

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[10]Katsuhide Takahashi, "Mieno Cautions Postal System on Saving's Interest Rates," *Nikkei Weekly*, Nov. 29, 1993, 17.

[11]Katshuhide Takahashi, "Interest-Rate Regulation Urged Because of Postal Competition," *Nikkei Weekly*, Nov. 22, 1993, 21.

[12]"Ryudosei Yokin Kinri—Jiyuka e Meisou, Ge" [Deposit Interest Rate—Difficult Way to Liberalization, Part 2], Nihon Keizai Shimbun, Nov. 5, 1993, 7.

Tadashi Okuda, chairman of the Federation of Bankers Associations of Japan, insisted in 1993 that the interest offered on postal savings deposits should be lowered to what private banks offer.[13] Takashi Tanaka, chairman of the Regional Banks Association, a group of smaller banks, said more strongly that "Regional banks will not accept the liberalization unless the postal savings system lowers its ordinary deposit rate to the level of deposit rates at commercial banks. This is a precondition of liberalization."[14]

If the postal savings system were to lower its interest rate, liberalization would ironically lead to smaller returns for depositors.[15]

Refuting the mounting criticism, an MPT official said that private banks should make efforts to raise deposit interest rates through streamlining operations before they attack postal savings.[16] According to Hiroshi Tanaka, director of the general affairs division at MPT, differences in the nature of public and private funds account for the differential in the rates: "The postal funds stay in the same account for three months on average because most customers are individuals, while the funds in private bank accounts stay just 0.06 months because most customers are firms."[17]

In the conflict in the United States, banking regulators supported the commercial banking industry and the SEC supported the securities industry. Similarly, in the conflict between commercial banks and the postal savings system, Japan's Ministry of Finance represents the interests of the commercial banks in attempting to persuade the MPT to lower the interest rate of the postal savings system to the average market rate after liberalization. Unlike disputes among industries controlled by a single regulator, there is no mediator for negotiations between ministries. Yasuaki Hiruta, an analyst at Norinchukin Bank, said that "the Ministry of Finance hopes to settle the dispute by the end of 1993, so banks can have time to prepare for the June changes. But the timing may need to be delayed because private banks and the Postal Ministry have not narrowed their differences."[18]

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[13] Katshuhide Takahashi, "Money Flow Termed Distorted by Postal Funds," *Nikkei Weekly*, Nov. 8, 1993, 16.

[14] Takahashi, "Interest-Rate Regulation," 21.

[15] "Ryudosei Yokin Kinri—Jiyuka e Meisou, Jou" [Deposit Interest Rate—Difficult Way to Liberalization, Part 1], Nihon Keizai Shimbun, Nov. 4, 1993, 5.

[16] Takahashi, "Money Flow," 16.

[17] Takahashi, "Interest-Rate Regulation," 21.

[18] Takahashi, "Mieno Cautions," 17.

6.2.4 Objections to Liberalization

Not surprisingly, some Japanese bankers, especially at smaller commercial banks, object to the liberalization of deposit interest rates. Tanaka of the Regional Banks Association called for gradual liberalization with retention of some deposit-rate restrictions.[19]

Japanese bankers, like some of their counterparts in the United States, often invoke "consumer benefit" when they oppose liberalization in order to protect their own interests. A commercial bank official says, "Depositors always pursue higher interest rates, but the higher rate will finally damage the benefit of consumers because it will raise the cost at commercial banks and raise the loan rates."[20] Hiroshi Sato, director of Takugin Research Institute, a subsidiary of Hokkaido-Takushoku Bank, says, "If the liberalization proceeds further, some banks will have to close unprofitable branches, and people living in the area will suffer inconvenience. The way to liberalization is the way to commercialism. It will lead to the abandonment of public interest."[21]

6.3 Competition in Lending

As **Table 6-5** shows, borrowing from commercial banks was the largest component of the debt of Japanese nonfinancial corporations at the end of 1992. Tight regulation of nonbank finance companies and of the capital market protected the turf of commercial banks, but increasing pressure for liberalization from outside sources has gradually prodded the Ministry of Finance into action.

6.3.1 Regulations on Nonbank Finance Companies

As discussed in **Chapter Three**, U.S. nonbank finance companies were able to offer competitive loan rates to customers by borrowing cheap funds through bond and commercial paper markets. In contrast, Japanese nonbank finance companies, which include leasing companies, consumer credit companies, and mortgage loan companies, were prohibited from issuing commercial papers in the domestic markets until July 1993: "The ministry had forbidden this on the premise that commercial paper might be some form of deposit. Receipt of deposits would put the nonbanks into an area of business reserved for banks."[22]

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[19]Takahashi, "Interest-Rate Regulation," 21.

[20]"Ryudosei Yokin," 5.

[21]Hiroshi Sato, "Igi Ari Jiyuka" [Objection to Liberalization], *Kinzai Weekly*, May 24, 1993, 64.

[22]Akira Ikeya, "New Rules Expand Fund Sources for Nonbanks," *Nikkei Weekly*, Dec. 20, 1993, 14.

Table 6-5

Liabilities of Nonfinancial Corporations in Japan (at the End of 1992)

	¥ Trillions	Percentage of Total
Borrowing		
Commercial Banks*	301	43
Others**	242	35
Industrial Bonds	47	7
Stocks	66	10
Foreign Bonds	35	5
Total	692	100

*"Commercial Banks" include banking accounts and trust accounts of eleven city banks, 132 regional banks, seven trust banks, and three long-term credit banks.
**"Others" includes financial institutions for small business (Shinkin Bank, credit cooperatives), financial institutions for agriculture, forestry and fishery, insurance companies, and leasing companies, etc.

Sources: Data for Borrowing from commercial banks from Bank of Japan, "Loans and Discounts Outstanding by Industry," *Economic Statistics Monthly*, October 1993, 106ff.; Other data from "Flow of Funds Accounts," 165.

The success of U.S. finance companies such as General Electric Capital Corp and General Motors Acceptance Corp stimulated enthusiasm in the Japanese nonbank finance companies. Major leasing companies, which saw that the difference between the U.S. nonbanks and themselves lay in their funding sources, requested that the Ministry of Finance lift the restriction.

Even before the issuance of commercial paper was officially approved, two leasing companies succeeded in issuing ABSs, a type popular among U.S. financial firms. In 1992, the Orix Corp and Japan Leasing established special-purpose companies to buy part of their leasing credits. The leasing firms securitized credit into small units which they sold to investors. The maturity periods of these instruments varies from several months to several years.[23] Although the Ministry of Finance opposed this move, the Ministry of International Trade and Industry (MITI) supported it, interpreting ABSs as outside the jurisdiction of the

[23]Ibid.

Ministry of Finance because they were not strictly "securities" as defined by Japan's Securities Exchange Act.

In July 1993, the Ministry of Finance finally approved the issuance of commercial paper by nonbank finance companies, under certain conditions. To issue commercial paper, a nonbank must either be listed on the stock exchange or, if unlisted, must disclose annual financial statements for the past three years. It also must hold a debt rating of A-2 or better. The Ministry said only about twenty nonbanks qualify.[24]

6.3.2 Regulations on Capital Markets

Japan's Ministry of Finance regulated the capital markets much more tightly than the U.S. regulators. The main purpose of Japanese capital market policy seems to have been (*i*) to avoid conflict between the commercial banking industry and the securities industry and (*ii*) to protect investors from "risky" investments, such as U.S. junk bonds.

Although no legislation prohibited the issuing of commercial paper, it was administratively prohibited until 1987. The commercial banking industry strongly opposed the introduction of commercial paper, which competes directly with short-term loans or floating rate loans, its main business, and exerted influence on the Ministry of Finance. Issuing floating rate bonds was prohibited until 1993, because it also competes with floating rate loan of commercial banks.

Issuing medium-term notes with a maturity of less than six years was also prohibited until 1992, to avoid conflict with three long-term credit banks that issued bank debentures maturing before five years.

To protect investors from "risky" bonds issued by highly leveraged companies, until October 1993 the maximum balance of corporate bonds issued by a company was limited to twice the amount of its net capital. Companies that issue unsecured bonds were required to have at least single-A ratings from credit rating agencies approved by the Ministry of Finance. As a result of such tight regulation, at the end of 1992 the total outstanding value of the Japanese bond market was only a third that in the United States, and the market was dominated by government bonds and bank debentures (**Table 6-6**).

In the 1980s, however, there was less demand for liberalization of this market. In those years, helped by the favorable performance of the Japanese stock market, nonfinancial corporations raised cheaper funds more easily by selling new stocks than through the bond market. **Table 6-7** shows the amount of stocks issued in Japanese stock market. In the same

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[24] Ibid.

Table 6-6

U.S. and Japanese Bond Markets: Breakdown of Outstanding Values (at Year-End)

U.S.: $6.3 Trillion (1991)	
Treasury bonds	30%
Corporate bonds	29%
Others	41%
Japan: ¥250 Trillion (1992)	
Government bonds	40%
Bank debentures	31%
Corporate bonds	14%
Others	15%

Source: Bond Underwriters Association of Japan. Quoted in Shigeru Wada, "Secondary Market Restrains Straight Bonds," *Nikkei Weekly*, November 15, 1993, 16.

Table 6-7

Stocks Issued: Amount of Paid-in Capital (For the Year Ended in March, ¥ Billions)

Year	¥ Billions
1981	1,160
1982	1,793
1983	1,015
1984	850
1985	814
1986	651
1987	632
1988	2,084
1989	4,564
1990	7,541
1991	665
1992	343
1993	471

Source: Yamaichi Securities Co. Quoted in Nomura Research Institute, "Securities Issued," *Quarterly Economic Review*, August 1987, 56, and February 1994, 77).

period, in order to escape from restrictions on the domestic market, Japanese nonfinancial corporations dramatically increased the issue of bonds in foreign markets (**Table 6-8**). Seeking diversification of investment, Japanese investors increased purchases of foreign securities (**Table 6-9**). A large portion of the bonds issued by Japanese corporations in foreign markets was purchased by Japanese investors or subsidiaries of Japanese corporations. Negotiations on terms and conditions of the bonds were often held in Tokyo.[25]

Table 6-8

Overseas Issues by Japanese Corporations (for the Year Ended in March, $U.S. Millions)

	Straight Bonds	Convertible Bonds	Bonds with Warrants
1981	1,083	2,394	—
1982	554	4,477	189
1983	3,746	2,544	262
1984	4,909	5,078	1,400
1985	7,938	5,064	1,761
1986	10,827	4,100	4,329
1987	16,804	3,085	12,539
1988	9,594	7,652	24,306
1989	12,738	8,199	38,513
1990	17,021	12,150	58,306
1991	33,963	3,656	19,079
1992	33,124	4,575	27,231
1993	39,632	1,943	13,294

Source: Nomura Securities Co. Quoted in Nomura Research Institute, "Securities Issued," *Quarterly Economic Review*, August 1987, 56, and February 1994, 77).

Thus, because nonfinancial corporations could procure quite large funds through both the domestic stock market and foreign bond markets, they were not very inconvenienced by the tight regulations on the domestic bond market. Further, because the Ministry of Finance had ordered bond issuers to appoint Japanese security houses as the leading underwriters and Japanese commercial banks as trustees even in foreign markets, the financial institutions had no incentive to demand liberalization of the domestic bond market.[26] As a result, in the year ending March 1990, the amount of straight bonds issued in the domestic market shrank to 729

[25]Yoshiro Miwa, "Kinyu Gyosei Kaikaku," Nihon Keizai Shimbun-sha, 1993, 54.

[26]Ibid., 75.

Table 6-9

Investment in Foreign Bonds by Japanese Residents
($U.S. Billions)

	Purchase	Sale	Net Purchase
1980	30	26	4
1981	9	4	6
1982	17	11	6
1983	23	10	13
1984	56	30	27
1985	291	238	54
1986	1,347	1,254	93
1987	1,274	1,201	73
1988	1,364	1,278	86
1989	1,684	1,590	94
1990	1,372	1,343	29
1991	1,233	1,165	68
1992	1,028	992	36

Source: Ministry of Finance. Quoted in Nomura Research Institute, "Investment in Foreign Securities by Japanese," *Quarterly Economic Review*, August 1987, 63, and February 1994, 85).

billion yen ($6.6 billion) from the peak of 1,269 billion yen in the year ending March 1982 **(Table 6-10)**.

The decline of the Japanese stock market and the onset in 1990 of an economic recession changed this situation. It was almost impossible to sell new stocks in the market in the period of 1991-93, and commercial banks, suffering from large amounts of bad debt, have become very cautious in lending. Nonfinancial corporations have turned to the bond market since 1991 (see **Table 6-10**) and both increased the issue of bonds and increasingly requested the liberalization of this market. The decline in new issues and in the trading volume in the stock market encouraged the securities industry also to turn to the bond market and seek its further liberalization.

The rapid growth of other Asian capital markets, such as Singapore and Hong Kong, may have been another factor in the liberalization of the Japanese capital market. Because the trading hours of those markets overlap those of the Japanese market, they may bring more direct competitive pressure on the Japanese market than either New York or London.

Table 6-10

Domestic Bond Issues
(For the Year Ended in March, ¥ Billions)

	Straight Bonds	Convertible Bonds	Bonds with Warrants
1981	994	97	—
1982	1,269	526	20
1983	1,048	418	47
1984	683	861	17
1985	720	1,612	3
1986	944	1,586	55
1987	980	3,468	104
1988	915	5,055	—
1989	749	6,995	—
1990	729	7,640	915
1991	2,066	911	395
1992	2,427	1,279	382
1993	3,820	575	—

Source: Bond Underwriters Association of Japan. Quoted in Nomura Research Institute, "Securities Issued," *Quarterly Economic Review*, August 1987, 56, and February 1994, 77.

In response to requests from nonfinancial corporations and security houses, the Ministry of Finance has loosened some regulations since 1992. First, bond issues that mature in less than six years were approved in 1992. Second, issuing floating-rate notes was approved in 1993. Finally, some restrictions on the qualifications of issuers were loosened: in October 1993, the limit on the balance of bonds per company was removed, and the credit rating required for unsecured bonds was lowered to triple-B from single-A.

Just as the growth of government bonds led to Gen-saki trading (see section **6.2.2**) and the development of commercial paper and certificates of deposit led to money management funds, the liberalization of the bond market may produce other new financial products. With expansion of the market and an increased number of participants, the demand for further liberalization will increase.

6.4 Dispute over the Boundaries between Commercial Banks and Security Houses

Commercial banking and the securities business traditionally were separated in Japan, even before the Amendment to Securities Exchange Act in 1948 prohibited commercial banks from entering the securities business. The dispute over the boundaries between these

institutions revived in the early 1980s. When security houses began to threaten the share of bank deposits through new types of investment trusts such as Chukoku funds (see section **6.2.1**), which are mostly invested in government bonds, commercial banks complained that they themselves were not permitted to participate in the sales and dealing of government bonds even though the government asked them to purchase a large amount of them.[27]

In April 1983, the Ministry of Finance approved sales of government bonds by commercial banks in order to expand outlets for government bonds and respond to the commercial banks' requests. In June 1983, in return for permitting commercial banks to enter into government bond sales, security houses were allowed to provide loans secured by government bonds.

Following the cross entries in 1983, commercial banks were allowed to participate in trading of government bonds (June 1984), to establish investment advisory subsidiaries (June 1985), and to deal in bond forward transactions (October 1985). Security houses were permitted to deal in bankers acceptances (April 1985), to trade in certificates of deposits (June 1985), and to provide revolving loans secured by government bonds (August 1985).

Japanese commercial banks have operated in the securities business under less regulated circumstances: in 1979, the Long-Term Credit Bank of Japan started bond underwriting and trading business through its London subsidiary; in 1986, the Industrial Bank of Japan acquired A.G. Langston, a New York-based primary dealer of U.S. treasury bonds;[28] and in 1987, the Bank of Tokyo established a security subsidiary in New York.[29]

The same holds for Japanese security houses. In 1986, Nomura Securities received a banking license from the Bank of England and entered the commercial banking business through its London subsidiary. Daiwa Securities, Nikko Securities, and Yamaichi Securities also entered the commercial banking business through their London subsidiaries, in March 1987, June 1987, and February 1988, respectively.[30]

From experience in both domestic and foreign markets, Japanese commercial banks have gained know-how in the securities business that has led to even stronger demands for permission to enter this area further. Security houses required administrative approval for entry into the turf of commercial banks, such as foreign exchange transactions and trusts.

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[27]Kyosuke Takase, "Kinyu henkaku to kinyu sai-hensei," 58.

[28]A security dealer authorized to participate in bidding for U.S. treasury bonds.

[29]Hiroshi Kusumoto, "Kinyu seido kaikaku de kawaru ginko shoken gyomu" [Banking and Securities Business Changed by Financial Reform]," Toyo Keizai Shimpo-Sha, 1990, 124-125.

[30]Ibid., 127-128.

After seven years of discussion since the Financial System Research Council started work in 1985, exploring ways to deal with conflicts, the Financial System Reform Act was passed by parliament in June 1992, permitting cross entries between commercial banks and security houses through their subsidiaries. The Ministry of Finance announced guidelines related to the reform in December.

The guiding principle of reform was "to maintain a balance between new opportunities and the old players."[31] Accordingly, only long-term credit banks and trust banks were allowed to establish security subsidiaries in 1993, while other commercial banks must wait until 1994. Security subsidiaries can trade in straight bonds but are not permitted to deal in stocks. They can underwrite, but not trade in, convertible bonds and warrant bonds (**Table 6-11**). In return for the commercial banks' entry into the securities business, security houses were allowed to establish trust bank subsidiaries in 1993 but not allowed immediate access to special large-lot securities trusts and special loan trusts in which public funds are invested. This protects the territory of trust banks.[32]

Table 6-11

What the Security Subsidiaries Can Do

	Primary Market	Secondary Market
Straight bonds	Yes	Yes
Convertible bonds	Yes	No
Warrant bonds	Yes	No
Stocks	No	No
Stock Index	No	No

Source: Long-Term Credit Bank of Japan. Quoted in Robert Thomson, "Sun Rises on a New Financial Era in Tokyo," *Financial Times*, July 26, 1993.

An economist, Akiyoshi Horiuchi of Tokyo University, criticized these guidelines:

> The most efficient structure for financial intermediaries can change according to various conditions, such as new communications technology and computers, and it is not easy to predict the change. The business area of each financial intermediary should be decided by the

[31]Robert Thomson, "Sun Rises on a New Financial Era in Tokyo," *Financial Times*, July 26, 1993.

[32]Ibid.

intermediary itself, then those with the most efficient structures will survive and will provide the best service for consumers. As usual, Japanese financial reform places great importance on the interests of existing financial intermediaries. The consumers benefit, the phrase that the Ministry of Finance likes to use, is neglected.[33]

6.5 Recent Performance of Japanese Commercial Banks

According to Helen A. Garten, professor of law at Columbia University, "Heavily regulated industries do not have a tradition of self regulation."[34] This observation seems to apply to the Japanese commercial banking industry. In the 1990s Japanese commercial banks confronted a serious deterioration in lending assets, although the quality of the loans, as was the case with U.S. banks, was periodically examined by regulators.

As **Table 6-12** shows, in fiscal 1991[35] Japanese commercial banks reported a decline in earnings for the third straight year. The Federation of Bankers Associations of Japan explained the background of this decline as follows.

Table 6-12

Net Income of All Commercial Banks in Japan (For the Year Ended in March, ¥ Billions)

Year	¥ Billions
1989	2,340
1990	2,169
1991	1,816
1992	1,399

Note: "All commercial banks" are defined as eleven city banks, sixty-four regional banks, sixty-eight member banks of the Second Association of Regional Banks, seven trust banks, and three long-term credit banks.

Source: Federation of Bankers Associations of Japan, "Financial Statements of Japanese Banks (FY 1991: April 1991–March 1992)," *Zenginkyo Financial Review*, 14, 1993.

[33]Akiyoshi Horiuchi, "Gyoumu bunya kisei no houkou wo megutte" [Direction of Deregulation on Business Territory], *Jurist*, June 1, 1993, 11-12.

[34]Helen A. Garten, *Why Bank Regulation Failed: Designing a Bank Regulatory Strategy for the 1990s* (Westport, Ct.: Quorum Books, 1991), 151.

[35]The Japanese fiscal year ends March 31; fiscal year 1991 started April 1, 1991, and ends March 31, 1992.

(*i*) Net interest income rose significantly, because the market rates at which banks procure funds declined before interest rates on lending started to drop with the move toward lower interest rates. However, (*ii*) banks posted very large losses because of the devaluation of stocks and other securities and (*iii*) transferred a very large amount to reserves for possible loan losses against the background of the slowdown in the national economy.[36]

Although the Ministry of Finance reported that the amount of loans in arrears at the top twenty-one commercial banks was 12.8 trillion yen (3.2 percent of total loan) as of March 31, 1993, the International Monetary Fund (IMF) estimated the amount would reach between 26 trillion and 30 trillion yen if it included loans for which commercial banks voluntarily reduced interest rates to support borrowers.[37] Most of the bad debt resulted from the slump in the Japanese real estate market, into which commercial banks had poured funds throughout the 1980s.

As mentioned earlier, Japanese commercial banks were protected by several regulations against capital markets and nonbank financial firms, and therefore did not experience the kind of intense competition from outside the industry as the U.S. commercial banks confronted. Nevertheless, in trying to expand their lending assets and in seeking higher returns, they significantly increased lending to the real estate sector, which in the 1980s was very aggressive in borrowing and investing (**Table 6-13**).

The commercial banks also poured funds into the real estate market indirectly, through nonbank finance companies. Increased vacancies and falling real estate prices forced many finance companies into a crisis, and commercial banks had great difficulty collecting on loans to finance companies. The slump in the real estate market thus pulled down the profits of commercial banks directly and indirectly.

According to Tohru Nakakita, assistant professor of economics at Toyo University, the commitment of regulators to avoid bank failures was interpreted as a kind of official guarantee to continue business and imported a moral hazard into the Japanese commercial banking industry.[38] Although there have been several bank failures in Japan, regulatory authorities make every effort to get other banks to absorb the one in difficulty. The most remarkable

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[36]Federation of Bankers Associations of Japan, "Financial Statements of Japanese Banks (FY 1991: April 1991–March 1992)," *Zenginkyo Financial Review*, No. 14, 1993.

[37]"Fukadou shisan 26-30 chou yen ni" [Nonperforming Assets Reach 26-30 Trillion Yen], Nihon Keizai Shimbun, Jan. 21, 1994, 1.

[38]Tohru Nakakita, "Ginkou no san-nyu taishutsu ga hajimaru" [Banks' Entry and Exit Start], Ekonomisuto, June 22, 1993, 51.

Table 6-13

Real Estate Lending by Japanese Commercial Banks (Outstanding Balance at the End of Year)

	¥ Trillions	Percentage of Total Loans
1992	47.5	12%
1990	42.4	11%
1985	20.1	8%
1980	9.1	6%

Sources: Bank of Japan, "Loans and Discounts by Industry, Banking Accounts of All Banks," *Economic Statistics Annual*, 1980, 133-136, 155; 1985, 129-132, 137; 1991, 133-136; *Economic Statistics Monthly*, October 1993, 106-107.

difference between the Japanese Deposit Insurance Corporation (JDIC) and the U.S. FDIC is that JDIC has never made a payout.[39]

Japanese commercial banks also have increased the ratio of personal loans per total loans, from 10 percent in 1980 to 16 percent in 1992 (**Table 6-14**). Their operating profit remains largely dependent on net interest income (**Table 6-15**), however, not only because their securities-related business has been strictly regulated but also probably because they have had little incentive to expand their business area while regulations protected their core business from competitors outside the industry.

Because of the departure of creditworthy borrowers and the increase of bad debt in wholesale lending, U.S. commercial banks expanded the ratio of retail loans per total loans and developed other revenue sources such securities trading and fees from asset management.

[39]Shoichi Royama, "Financial Intermediation and Liberalization in Japan," *Regulating International Financial Markets: Issues and Policies*, edited by Franklin R. Edwards and Hugh T. Patrick (Kluwer, 1992), 115.

Table 6-14

Loans to Individuals by Japanese Commercial Banks (Outstanding Balance at the End of Year)

	¥ Trillions	Percentage of Total Loans
1992	66.0	17%
1990	61.2	16%
1985	25.7	10%
1980	18.7	12%

Sources: Bank of Japan, "Loans and Discounts by Industry, Banking Accounts of All Banks," *Economic Statistics Annual*, 1980, 133-136, 155; 1985, 129-132, 137; 1991, 133-136; and *Economic Statistics Monthly*, October 1993, 106-107.

Table 6-15

Composition of Operating Profit: All Japanese Commercial Banks (For the Year Ended in March, ¥ Billions)

	1990		1991		1992	
Net Interest Income	7,522	(77%)	7,126	(75%)	8,858	(82%)
Fees and commissions	1,074	(11%)	1,022	(11%)	906	(8%)
Commissions on trust account	745	(8%)	647	(7%)	585	(5%)
Other operating profits	430	(4%)	712	(7%)	438	(5%)
Total	9,771	(100%)	9,507	(100%)	10,787	(100%)

Sources: Federation of Bankers Associations of Japan, "Financial Statements of Japanese Banks (FY 1990: April 1990–March 1991)," *Zenginkyo Financial Review*, 11, 1991. Federation of Bankers Associations of Japan, "Financial Statements of Japanese Banks (FY 1991: April 1991–March 1992)," *Zenginkyo Financial Review*, 14, 1993.

Chapter Seven

Summary

This analysis of the behavior of major players in financial services primarily in the United States but also in Japan yields several findings.

(*i*) A number of commercial banks regard computers and new communications technologies as a critical weapon in market competition as well as part of their close relations with customers. They use new technology extensively both in traditional business and in new businesses, such as custodial service and securities trading.

(*ii*) Information technology is not limited to uses in commercial banking industry. It has supported the expansion of capital market instruments, such as corporate bonds and commercial papers, and innovative financial products, such as mutual funds and pension funds, and thus has helped them to make inroads into traditional commercial banking businesses. Nonfinancial firms have entered the credit card business and other financial services by establishing advanced computer systems and building on an existing customer base.

(*iii*) As shown here, in Japan the expansion of innovative financial products and their impact on existing regulations may be minimal, especially when those products are regulated administratively, not just legislatively. The emergence of mutual funds has made ceilings on deposit interest rates obsolete, and, similarly, some financial products developed through the use of information technology can change or by-pass regulations to some extent. Even in Japan, where advances in technology lowered transaction costs and the gap between this country and others (especially the United States) in the availability of various financial products has widened, providers and users of financial services are increasingly demanding the liberalization of corporate bonds, commercial papers, and other financial products. This growing demand is gradually having an affect on the regulators.

(*iv*) In both the United States and Japan, the profits of commercial banks have been damaged by the deterioration of lending assets rather than by a decrease in revenues owing to a decline in lending. The departure of creditworthy borrowers to capital markets may be one factor driving commercial banks to risky lending. Other factors cannot be ignored, such as the boom in leveraged buy-outs, the rapid upsurge in the real estate market, and the lack of a tradition of self-regulation at most commercial banks.

(*v*) U.S. commercial banks have rapidly recovered profitability since 1992, helped by the decline of the short-term interest rate, improvement in asset quality, and reduced operating

costs. The decline in the commercial banks' share of financial services, however, may cause long-term problems in profits.

(*vi*) Because of the deterioration in wholesale lending assets in the late 1980s, many U.S. commercial banks are changing the nature of their business, shifting from wholesale to retail lending, expanding fee and trading business, or entering new areas such as sales of securities and insurance. Advanced computer systems support commercial banks in most of these areas.

(*vii*) The U.S. commercial banking industry is consolidating through mergers and acquisitions. Both the shrinking of the total marketshare of commercial banks in financial services and the presence of economies of scale and scope introduced mainly by active use of computer facilities may be considered important to the increase in mergers and acquisitions.

(*viii*) If most retail clients of commercial banks had compared the fee of each bank and chosen the lowest, the banks would not have been able to raise fees so rapidly as they have done since 1990. Some investors have suffered large losses from investments in complicated financial assets such as IOs, without correctly understanding the risk. Such experiences indicate that in the competitive financial world, users of financial services need to understand and compare various financial products and services to obtain better services from financial institutions or markets.

(*ix*) In the 1990s, for credit analysis of borrowers, financial institutions and bond investors are increasingly dependent on information provided by credit rating agencies or consumer credit bureaus. The importance of credit information providers is increasing: firms rated below double-B or individuals with negative credit profiles will face difficulties in borrowing regardless of the type of institution to which they apply.

(*x*) In the United States and Japan, the players in the financial services industry often use the phrase "consumer benefit" both to attack regulations that protect a particular industry and in seeking to maintain those that protect the players themselves.

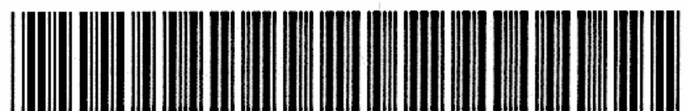
(*xi*) In the conflicts between different financial industries, regulatory authorities support and represent the interests of the industry they control. In the United States, banking regulators support the entry of commercial banks into the business of securities and insurance, while the SEC tries to restrict it. Even in Japan, where the Ministry of Finance is the sole regulator controlling almost all financial institutions, the Securities Bureau has supported liberalization of capital markets and of the new financial products that compete with bank deposits, while the Banking Bureau has hindered the liberalization to protect commercial banks.

(*xii*) Taking the opposite view, many experts in the United States and in Japan, including leaders in the financial industry and economists, insist that regulatory protection of a particular industry could well damage the consumer benefit, because it would limit free-market competition, which provides the best service for consumers.

(*xiii*) To protect investors from risky financial assets and protect the interests of individuals or small businesses as users of financial services, regulatory authorities in the United States and Japan proposed or imposed several rules. In the United States these rules include: proposed legislation on ceilings for credit card interest rates; the Community Reinvestment Act; and proposed regulations on derivatives. In Japan they include: a minimum credit rating requirement for bond issuers and restrictions on the use of derivatives by investment trusts. Most such regulations have either harmed or have the potential to harm the interests of investors or consumers of financial services through side effects that regulators ignore or cannot predict. Some regulations were rejected or modified for that reason.

Acronyms

ABA	American Bankers Association
ABS	asset-backed security
ATM	automatic teller machines
BIS	Bank for International Settlements
CRA	Community Reinvestment Act of 1977
CRE	commercial real estate
DIDMCA	Depository Institution Deregulation and Monetary Control Act 1980
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
HLT	highly leveraged transactions
IMF	International Monetary Fund
IO	interest-only strip
JDIC	Japanese Deposit Insurance Corporation
LBO	leveraged buy-outs
LDC	less developed country
MITI	Ministry of International Trade and Industry
MPT	Ministry of Posts and Telecommunications
NASDAQ	National Association of Securities Dealers Automated Quotation system
NOW	negotiable order of withdrawal
S&L	savings and loan
SEC	Securities and Exchange Commission
USPIRG	U.S. Public Interest Research Group



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