

Final draft: November 14, 2002

Benefits and costs of integrated financial services provision in developing countries

By

Stijn Claessens

University of Amsterdam and CEPR

This paper analyzes the benefits and costs of integrated financial services provision (IFSP), that is, the ability of a financial institution to provide all types of financial services under one roof, with special reference to developing countries. Most analytical and empirical work to date finds IFSP to be beneficial for economies and firms as it enhances the efficiency of the financial sector, widens access to financial services, and reduces financial sector specific and overall economic volatility. The (limited) available evidence for emerging markets is even stronger. It also suggests important static and dynamic gains from IFSP, particularly in developing non-bank financial services such as pension and insurance services. Possibly reflecting these greater gains, emerging markets have a relatively large presence of financial conglomerates when considering the restrictions their governments impose. IFSP can have risks, however, and requires enhanced regulation and supervision in some areas, especially to prevent (more) leakage from any publicly-provided safety net, and puts more emphasis on ensuring a contestable financial system.

Paper presented at the Joint Netherlands-U.S. Roundtable on Financial Services Conglomerates, co-hosted by The Government of the Netherlands and Brookings-Wharton Papers on Financial Services, to be held in Washington, D.C., October 23-25, 2002. Contact: Finance Group, University of Amsterdam, Roetersstraat 11, 1018 WB Amsterdam, The Netherlands; phone 31-20-525-6020; secretary 31-20-525-4256; fax 31-20-525-5285; Email address: stijn@fee.uva.nl. I would like to thank Frans van Loon and colleagues for stimulating discussions and useful comments, and the conference participants for their useful comments. The paper draws on joint work with Daniela Klingebiel. Opinions expressed do not necessarily represent those of the co-hosts.

1. Introduction

Many countries, especially developing countries, have been reforming their financial systems over the past two decades. These reforms have involved the removal of barriers to entry, the reduction of portfolio restrictions and lowering of directed lending requirements, and the general removal of many product limits. An important part of the reform efforts has been the dismantling of regulatory barriers separating banking, insurance, and securities activities. Legal and regulatory boundaries between different financial intermediaries have been rapidly disappearing in many countries, as in the repeal in 1999 of the Glass-Steagall Act in the United States. Integrated Financial Services Provision (IFSP) is becoming the norm around the world, with many countries having today no or very few restrictions on the ability of banks to offer, besides commercial banking services, securities, asset management or insurance services.

Market forces have in part driven reductions in barriers between financial services. An important market incentive for the widening of scope by banks has been the disintermediation of bank assets and liabilities by capital market transactions. The disintermediation has pressured banks to expand their financial services to cater to a greater set of customer needs and preferences. Technological innovations have been another important driving force as it has provided financial institutions with a greater ability to deliver multiple financial services and exploit economies of scope. Regulators have responded to these market forces with the removal of restrictions.

While in part a response to market forces, the issue of IFSP has not been without controversy. In the U.S., for example, debates about universal banking go back at least to the 1930s. Experiences then showed in the eyes of many the weaknesses of a universal banking model. The separation of commercial and investment banking then adopted in the U.S. through the Glass-Steagall Act spread over time to many other countries, especially developing countries. IFSP has also been a debated topic in emerging markets, partly in light of the financial crises emerging markets have experienced in the last decade. Some observers have attributed the crises partly on excessive deregulation, including allowing banks to enter into securities and insurance business.

The purpose of this paper is to review the current knowledge on the issue of IFSP with special emphasis on developing countries.¹ It defines IFSP as the situation in which a financial institution is able to provide all types of financial services (commercial and investment banking, securities markets, asset management, and insurance services) under one roof. Models of IFSP include universal banking, bancassurance and other models, such as bank holding companies engaged in multiple type of financial services. To position the analysis, and since IFSP is to a large degree about the scope of permissible activities of a bank, section 2 starts with a short review why the powers of deposit-taking financial institutions (“banks”) are being regulated in the first place. The section also reviews recent global trends in financial services provision, especially those affecting changes in the demand for and supply of different types of financial services. Section 3 provides background on the degree to which the current regulatory framework allows IFSP in most developed countries and major emerging markets.

Section 4 reviews the analytical and empirical evidence on the costs and benefits of IFSP, at the level of the financial sector, firms, consumers, and the overall economy. Aspects analyzed include the performance and efficiency of the financial sector itself; the access to and the costs of financial services for firms and households; and the possible reductions or increases in risks for the economy and the financial sector. It reviews available empirical studies on financial institutions, households, individual country, and cross-country studies, both for developing countries and developed countries, including pre-Glass-Steagall in the U.S., and from recent changes.

Section 5 analyzes the issues of IFSP in developing countries and reviews issues of specific relevance to emerging markets. It reviews the degree to which one observes financial conglomerates in emerging markets and the problems that are more typical in these settings. Section 6 concludes.

2. Why regulate banks?

Before analyzing the specific regulatory arrangements for IFSP, I review the arguments for the general case for banking system regulation. After all, and different from non-bank institutions, it is regulations rather than the market which defines a bank and the type of permissible activities a bank can be involved in. As further background, this section also reviews recent trends in financial services provision as

they affect the desires of banks to enter into securities activities and other type of financial services.

Why regulate banks? Arguments for banking system regulation hinge on the special nature of banks, where a bank's illiquidity and its fallout on the stability of the financial sector can cause real sector consequences. Banks have traditionally been considered special because they provide liquidity services to other firms and manage the flow of payments throughout the economy. Disruptions in the liquidity supply and a breakdown in the payments system can have large spillover effects for the rest of the economy in terms of reduced real output. Bank failures or losses in capital can lead to contractions in aggregate bank credit, for example, with large social costs to bank borrowers outside the banking system. Banks are also inherently fragile and susceptible to contagious runs owing to the combination of information asymmetries, intertemporal contracting, demandable par value debt, and high leverage (Diamond and Dybvig, 1983). Even small shocks to solvency may lead to costly systemic runs, where depositors overreact to information and force the closure of even solvent institutions. The importance of banks for the smooth functioning of an economy and the vulnerability of their own financial structures has led government to treat banks "special."

It has also been argued that banks are special because only banks can provide some essential forms of credit to corporations, especially forms of short-term liquidity. Kashyap, Rajan, and Stein (1999) argue that banks can provide short-term liquidity more cheaply than other institutions because they combine committed lending (such as lines of credit) with deposit-taking services. The authors contend that

banks are more cost-efficient in providing liquidity because deposits act like loan commitments, since deposits can be withdrawn at any time. As a result banks need a buffer stock of liquid assets to support their provision of demand deposits, just as they need a buffer stock to support their loan commitments. Since banks offer lending and deposit-taking services together, they can economize on the quantity of cash and safe securities they hold, thereby maintaining a smaller buffer than would be required by two financial intermediaries offering these services separately. These savings allow banks to provide liquidity to their customers at a lower cost than other financial institutions. Diamond and Rajan (1998) argue further that the somewhat fragile capital structure of banks, which subjects them to runs, disciplines them to monitor corporations properly.

While these characteristics have been recognized for some long time, many countries did not treat banks special from a government regulation point of view until the 20th century. In most countries, banks were private, unregulated entities. Historically, clearinghouses and other private monitors rather emerged to limit the risk taking of financial institutions and spillovers from one financial institution to others and the real economy. Private sector solution thus arose to deal with many of these concerns. In the last century or so, however, and especially following the Great Depression, governments have take a greater role in overseeing banks, including by providing a safety net for times of liquidity problems. These measures introduced problems of their own, in particular excessive risk-taking unchecked by depositors. Prudential regulation and supervision to prevent moral hazard and to limit bank opportunities to take more risk have therefore accompanied the safety net provision by governments. An important element of the regulatory framework put in place has

been restrictions on the type of activities banks are able to undertake. The degree of success of limiting the moral hazard and degree of risks taking arising from a public safety net has varied greatly among countries. Many financial crises, especially in emerging markets, are arguably due to the poor oversight and intervention of regulators in environments with too generous safety nets.

Recent changes in financial services industries. The nature of financial services provision has been changing rapidly in the last decade, which is affecting the desire and need of financial institutions, especially banks to widen their scope of activities, and in turn the costs and benefits of financial sector regulation. An important global trend in financial services industries has been the increased substitutability between various types of financial instruments. Many financial instruments are now available to households and corporations that provide similar kind of services. Bank deposits, for example, compete in many countries with other liabilities of financial intermediaries, such as money market funds, in the provision of savings and liquidity services, and often also payment services. Many insurance products have features similar to savings products. This has implied that the demarcation lines between different types of financial intermediaries and financial services have become increasingly blurred from both consumer and producer point of view. The demand and supply for various financial services have been altering as well. Consumers, households as well as corporations, are increasingly becoming more sophisticated and asking for a full package of financial services, preferably from a single provider. And, partly due to technological progress, producers are realizing that they can use existing client relationships more profitably by offering a wider package of financial services.

These changes are affecting the economic costs of regulatory barriers between different financial products and different types of financial institutions. As these barriers have become less effective, but still impose costs on individual financial institutions, their economic cost has risen. At the same time, the changes in the financial services industries and advances in technology have also been eroding the special nature of banks. The emergence of many substitutes for bank deposit and loan products and the fact that the proprietary information that the banks had on their borrowers is now cheaper and more widely available are altering the role of banks in providing liquidity and credit services. To the extent banks as deposit-taking and lending institutions have become less important to financial intermediation, there may be less of a need for a public safety net and associated prudential regulation, including those regulations which limit the provision of multiple types of financial products. In spite of these developments, few countries, however, have yet moved to reduce the scope of their public safety nets.

3. The scope of permissible activities in various countries

This section provides background on the actual degree to which financial institutions in various countries across the world are permitted to provide various types of financial services and analyzes recent trends in IFSP.

The limits on financial services provision across countries. While the special character of banks, insurance companies and other financial institutions may be

changing, financial institutions and especially banks and insurance companies are still heavily regulated everywhere. The regulation of banks and insurance companies takes the form of capital adequacy or equivalent requirements and other prudential regulations, such as maximum exposure limits. The scope of permissible activities of banks, insurance and other financial institutions is another important aspect of regulation. Most often, regulation rather than competition determines the range of products and services a financial institution can offer, the types of assets and liabilities it can hold and issue, and the legal structure of its organization. Two models at opposite ends of the permissible scope of financial services provision can be distinguished. A separate financial system, where banks are not allowed to engage in any type of securities or other, non-credit financial service activity, and vice-versa, insurance and securities companies are not allowed to engage in banking activities. And a completely integrated system, where a financial institution can provide all types of financial services, either directly or indirectly through subsidiaries.²

Financial services come in many forms, although if one unbundles the services, most, if not all, key elements are very similar (Bodie and Merton 2000 analyze the functions financial institutions and markets provide, rather than the specific products). Nevertheless, the rules governing the provision of financial services apply to their formal forms and not their functions. With the variety in financial products, it is difficult to capture for each country the rules in a simple form, but broadly financial services can be classified into three classes: banking services (credit, deposit, payments, etc.), securities related services (underwriting, market making, brokerage, asset management, etc.), and insurance services.³ Using data on 54 industrialized and emerging countries surveyed by the Institute of International

Bankers (IIB) in 2002, it becomes clear that allowing banks to provide securities services is the norm around the world (see Annex 1). Out of the 54 countries, only China has a “pure” separate banking system—in the sense that banks are not allowed to engage in any type of securities and insurance activities.

The majority (36) of countries surveyed, including all EU-countries, allow banks to conduct both banking and securities business, including underwriting, dealing and brokering all kinds of securities, within the same banking organization, without any restrictions.⁴ In 17 countries, financial institutions are allowed to engage—to varying degrees—in securities activities, either through a bank parent (13) or a bank-holding company structure (4). In terms of insurance services, fewer countries allow banks to provide full insurance services (either as principal or agent), only 6 out of the 54 have no restrictions whatsoever. Many countries, however, allow banks to provide insurance service through subsidiaries (26) or through affiliates (8). Only 14 out of the 54 countries do not allow banks to engage in insurance activities.⁵ These data thus shows that most countries allow full or close to full IFSP.

A broader, although slightly less recent survey than that of the Institute of International Bankers is Barth, Caprio and Levine (2001b). They document for 107 countries the regulatory restrictions in place in 1999 (or around that time) on the ability of commercial banks to engage in securities and insurance services (as well as real estate activities). Table 1 provides their overview (Annex Tables 2 and 3 reproduce the average for the whole sample by regional and income groups as reported in Barth et al. (2001b); Annex 2 also provides more detail on the definitions they used).⁶ It shows that about three-quarter (84) of the 107 countries surveyed

either have no restrictions whatsoever on banks providing securities services (43), or permit banks to do so either through a bank parent or a bank-holding company structure (41). Another seven countries allow less than a full range of securities activities to be conducted in a bank, and only six countries prohibit the provision of securities services by banks. In case of insurance services, the rules are generally less liberal, as was the case for the IIB sample of 54 countries. Only about half (54) of the 107 countries either have no restrictions whatsoever on banks providing insurance services (8) or permit it with some restrictions (47). About one-third, 34 countries, prohibit the provision of insurance services.⁷

Table 1: Restrictions on financial institutions' activities
(Number of countries)

Degree of restrictions	Type of Activity		Memo	
	Securities	Insurance	Real estate	Bank ownership of nonfinancial firms
Unrestricted	43	8	16	14
Permitted	41	47	19	38
Restricted	17	18	32	48
Prohibited	6	34	40	7
Total	107	107	107	107

Source: Barth, Caprio and Levine, 2001b

No or few restrictions on securities activities is thus more the norm than perhaps expected. The perception of a general prevalence of restrictions on banks'

activities may have arisen in part because the U.S. used to have quite restrictive regulations on the types of securities businesses which could be undertaken by commercial banks—mainly only through a bank holding company structure, and even then subject to some limits.⁸ Combined with the fact that the majority of academic studies have been US-focussed, this may have led to the perception of widespread restrictions around the globe. In practice, however, US financial institutions have been engaged in some degree of IFSP using various exemptions for some time. And since the Gramm-Leach-Bliley (GLB) Act of 1999, financial services providers in the U.S. are also formally free to provide both banking, securities and insurance services under one roof (see, among other, papers in McCoy, 2002 for more detail).

4. The conceptual and empirical case for and against IFSP

The majority of countries thus allow complete or nearly complete IFSP, or at least the combination of commercial and investment banking, and clearly the recent trend is towards greater freedom in allowing financial institutions to choose their preferred set of activities. This does not mean that financial conglomerates will become the dominant model for most financial institutions or most markets. What structure individual financial institutions choose if the permissible scope is wide—specialized, universal banks, bancassurance, use of alliances, etc.—will still vary and be determined by market forces. These strategic choices are not analyzed here (see Boot in this volume). IFSP nevertheless remains a debated topic, especially, but not only in emerging markets. This is in part as there are many aspects to consider with different scopes of financial services provision. These aspects include

the efficiency of financial services provision, access to financial services, financial sector stability, and issues of concentration of economic and political power. Theory offers some advantages and disadvantages on some of these aspects, while the empirical evidence has not always been conclusive, in large part, as data are limited. I review the arguments and the available empirical evidence to date.⁹ I will often focus on the benefits and costs of integrated banking, i.e., the combination of commercial and investment banking, as that has been studied most, but I will also make reference to the undertaking of insurance activities by banks. I conclude with the findings of a number of recent, comprehensive studies that include many emerging markets.

Benefits of a Wide Scope of Financial Services Provision. Three benefits have been identified with fully IFSP: it increases profits through economies of scope, it reduces the variability of profits and it allows for the use of informational advantages.

Economies of Scope. Economies of scope may arise both from the production and consumption of financial services (Saunders and Walter, 1994). A larger scale production of elements common to these various financial services can lead to cost advantages through economies of scale. Several specific cost advantages which have been identified include: gains through concentration of risk management, administration functions, and integrated product development; marketing economies in the common delivery of different services; better information access and sharing of information across different product groups; reputational and pecuniary capital to be shared across different products and services; and enhanced potential for risk management through diversification gains. On the consumption side, economies of scope may derive from: the potential for lower search, information, monitoring and

transaction costs; negotiating better deals because of increased leverage; and lower product prices in a more competitive environment.

There is little empirical evidence of scope economies, possibly because financial institutions can not or do not choose their optimal institutional structure, but also because the measurement of banks' diverse set of output products and related inputs is complicated.¹⁰ The bulk of studies for US banks concludes that economies of scope in banking, if at all present, are exhausted at very low levels of output (Berger, Hanweck and Humphrey 1987; Berger, Hunter and Timme 1993). These studies may have limited relevance, however, as US banks were allowed to only offer limited investment banking services, and these activities had to be located in a separate subsidiary of the bank holding company.

Empirical studies on European banks, which may be more relevant as generally European countries allow more integrated banking, have been inconclusive. Lang and Welzel (1995) report the absence of scope economies in German universal banks, but find such economies in small cooperative banks. Vander Venet (2002) finds that European universal banks are characterized by significant higher levels of revenue efficiency relative to specialized banks and are also more profit efficient, suggesting some gains from integrated banking. He also finds superior monitoring capabilities on the part of universal banks.

These studies refer mainly to the combination of deposit taking banking with securities/capital market activities. The more recent approach is to combine banking, i.e., the combination of commercial and investment banking, with insurance and asset

management. Especially the combination of banking with insurance (“bancassurance”) is an important change and offers in principle large economies of scope, in terms of sales channels, product development, risk management, marketing, etc. The empirical evidence on the existence of economies of scope between banking and insurance service is very limited, however. One of the few studies is Carow (2002). He analyzed the Citicorp - Travelers Group merger that increased the prospects for new legislation removing the barriers between banking and insurance. He finds that the merger resulted in a positive wealth effect for institutions most likely to gain from deregulation. Life insurance companies and large banks (other than Citicorp and Travelers Group) had significant stock price increases, while the returns of small banks, health insurers, and property/casualty insurers were insignificantly different from zero. His study provides evidence that investors expected large banks and insurance companies to receive significant benefits from legislation removing barriers to bancassurance in the U.S.

Increased Diversification and Lower Risk. A bank engaged in IFSP may be more stable than a specialized financial institution because of diversification benefits. These benefits can arise from two sources. First, due to diversification the total profits of an integrated financial institution will be more stable than that of financial institution specialized in a single product. There is some evidence of these diversification benefits. Kwan and Laderman (1999) argue that since profits from providing different financial services are not very highly correlated, there are diversification benefits from allowing broader powers. Eisenbeis and Wall (1984) find a negative correlation between US bank earnings and securities broker/dealer earnings over the 1970 to 1980s period (see further Brewer, Fortier, and Pavel 1989 and

Benston 1990). While US banking organizations' securities subsidiaries tend to be more volatile (higher standard deviation of profits) than banking affiliates, securities subsidiaries provided diversification benefits to the bank holding company (Kwan 1997; see also Klein and Saidenberg, 1998).¹¹

The effect on risks of allowing banks to enter into insurance industries has been less analyzed. Studying the period before the removal of entry barriers in the U.S., Allen and Jagtiani (1996) found that “synthetic universal banks comprised of portfolios of banks, securities firms, and insurance companies have significant positive excess returns, with lower market and interest rate risk exposures and higher expected returns than securities firms.” This confirms the risk diversification benefits from IFSP, in their case attributed to the lower exposure to interest rate risk of a conglomerate that includes insurance activities. Anecdotal evidence regarding the actual financial performance of financial conglomerates, mostly from outside the US, also suggests that the integration of banking and insurance lowers the variability of income streams.

Second, dis-intermediation—when firms bypass banks and raise money directly from public markets or where they obtain other type of financial products from non-banks, including from insurance companies—will affect an integrated financial institution less because the decline in lending business can be offset by an increase in underwriting and placing business, and other, non-interest (fee) business. This in turn may reduce a financial institution's incentives to engage in riskier lending to maintain profits when faced with dis-intermediation. This effect is difficult to show at the individual bank level, but there is some support at the sectoral level that

financial systems with fewer restrictions are more stable (Barth, Caprio and Levine, 2001a, further reviewed below).

Thirdly, there may be important dynamic and broader economic impacts of IFSP on financial sector stability and efficiency, especially in emerging and developing countries more dependent of foreign capital. For an efficient utilization of external capital flows, and equally important, to avoid becoming dependent on possible volatile flow of external capital, the importance of sequencing reforms and assuring the domestic financial system is sufficiently developed before giving full freedom to external capital flows are increasingly recognized. More generally, a well-balanced financial system can reduce volatility and improve resource allocation (Easterly, Islam and Stiglitz 2001; World Bank 2001). Such a domestic financial system will include not only strong banks backed up by adequate regulation and supervision, but also well developed contractual savings—insurance companies, pension funds and various other forms of funded security systems. A wider scope of financial activities may help to develop these non-bank elements as incentives to do so are better balanced and scarce skills are used more efficiently. Again, this effect is difficult to show, but there is some empirical support that financial systems with fewer restrictions are more diversified (Barth, Caprio and Levine 2001a).

Informational Advantages. In establishing a relationship with a firm, a financial institution incurs costs in gathering information about the firm and its investment opportunity before making lending or investment decisions. The longer the expected duration of the financial institution-firm relationship, the more willing the financial institution will be to invest in gathering firm-specific information, which in turn can

increase the financing to the firm for valuable investment projects. Integrated financial institutions can offer a broader set of financial products than specialized financial institutions, which allows for lower information and monitoring costs. Information derived, for example, from managing a basic bank account can be used in the supply of other financial services. And when the bank also sells insurance products to a corporation or consumer, it may gain information useful for its lending activities. An integrated bank can also design financing contracts better suited to the borrower. Finally, as a firm switches from bank financing to raising money on the capital markets and demands a wider set of financial services, it can remain a customer if the bank provides lending, securities underwriting and insurance services.

Empirical research confirms that the close bank-firm relationship associated with integrated banking can be a source of important benefits to firms in terms of cost and availability of funding (Berger and Udell 1995; Petersen and Rajan 1994; Vander Venet 2002). For instance, expanded banking powers during the pre-Glass-Steagall in the United States are associated with a lower cost of capital and less stringent cash-flow constraints (Berger and Udell 1996, DeLong 1991 and Ramirez 1995, 2002). Essentially, informational advantages associated with integrated banking can turn advantages for banks into advantages for customers as they get better and cheaper services. These gains are not always obtained, however. Findings for German firms during the 1903-13 period, the forming year of universal banking, for example, suggest that relationship banking did not consistently lessen firm's liquidity sensitivity (Fohlin 1998).

The degree to which these informational advantages can be realized and passed on to the customer depends in part on the degree of informational asymmetries: in economies where information is generally poor, close bank-firm relationships could in principle be very useful (Rajan and Zingales 1999).¹² At the same time, a situation with weak information may mean that close bank-firm relationship leads to poor resource allocation due to the weak monitoring of banks themselves. The balance between these two effects will, among others, depend on the degree of competition in the financial sector and the quality of banking regulation and supervision. In low competitive environments with weaker information, banks are more likely to use their market power and retain the gains, rather than pass them on.

Potential Risks Associated with IFSP. IFSP can come with risks (John, John and Saunders 1994). These include most importantly conflicts of interest. In addition, increased financial risks and greater difficulty in monitoring integrated financial institutions are often mentioned as risks. Finally, IFSP can also affect competition and concentration of economic power in a country.

Conflicts of Interest. As a start, it is important to acknowledge that conflicts of interest are plentiful even in specialized financial institutions, i.e., when financial institutions are only allowed to offer certain types of financial services. For investment banks, for example, conflicts between research and underwriting activities have received much attention lately. As such, it has to be evaluated how much larger the scope for conflicts of interest is under a wider scope of activities. It is furthermore important to realize that the presence of potential conflict of interests among commercial banking, investment banking and insurance activities will depend on the

development of securities and insurance markets relative to traditional banking business. In many developing countries, at least until recent, securities markets and insurance markets were not that active. As a consequence, even when IFSP was allowed, the scope of conflicts was limited. Most importantly, markets and regulators have dealt with conflicts of interest issues within the same line of business or across businesses through reputation, voluntary codes and private standards, self-regulation and to some extent by government regulation and supervision.

The possibilities for conflicts of interest nevertheless increase in principle when financial institutions are allowed to offer a wider array of products and have a broad set of customers—as in IFSP. In the case of commercial banks' undertaking of investment banking activities, for example, conflicts of interest can arise in the bank's advisory role to potential investors, as when the bank may promote the securities of firms it is lending to even when better investments are available in the market. It can also arise because, in its role as a trust fund manager, the bank may be tempted to “dump” the unsold part of the securities it underwrites into the trust accounts it manages for bank depositors. Or a bank may encourage its insurance part that is engaged in asset management to buy at inflated prices certain securities it was underwriting.

Conflicts have are often identified as one of the major potential cost of permitting commercial banks to conduct securities business (Saunders 1985, Kelly 1985, and Benston 1990). Typically, a bank is better informed than the public investor is about a firm's soundness and prospects when it also lends to that firm. This informational advantage may, however, be a double-edged sword. On the

positive side, an integrated bank might be better positioned than a specialized investment bank to certify credibly the value of a security offered by the firm. On the negative side, an integrated bank might have a greater incentive and greater ability to take advantage of uninformed investors (e.g., sell low quality securities without revealing risks it knows from its lending relationship in an attempt to safeguard its lending portfolio; or it may simultaneously raise its lending rates to the same borrower). Similar issues can arise in the context of banking and insurance activities being provided by one single financial institution, although the literature has typically focussed on the conflicts between commercial and investment bank activities.

As in general regarding any potential conflicts, the critical issue is not whether they exist, but rather whether the incentives and opportunities to exploit them exist. Market forces in general, such as competition from other financial institutions, will reduce the incentives to exploit conflicts, as will potential damage to reputation and the monitoring by creditors and “non-market” monitors, such as rating agencies. When these conditions prevail, conflicts of interest have not been found to be misused in a systematic way. Earlier empirical studies for the German universal banking system have not found evidence of systematic abuse of conflicts of interest (Bueschgen 1970, Monopolkommission 1976/77). Also, Gorton and Schmid (2000) find that in 1974 German banks improved the performance of German firms in which they held equity. They found no evidence of conflict of interest in the use of proxy votes by German banks at that time.

More recent studies for the German universal banking system confirm these findings. Using ownership data and analysts' earnings per share forecasts on German

companies from 1994 to 1999, Lehar and Randl (2001) test for both informational advantages and possible misuse of conflicts of interests. They find evidence that banks have superior knowledge on firms where they own equity stakes, but also some evidence for conflicts of interest. Interestingly, they find that conflicts of interest are less pronounced for large equity holdings, suggesting that client pressure more than bank's self interest is the important driving force of overoptimistic forecasts with respect to equity valuation. As such, the conflicts do not seem to arise from the fact that German banks are universal banks, that is being underwriters while holding lending and sometimes equity stakes in corporations, but more from their role as underwriters and analysts.

In the pre-Glass-Steagall in the United States, it has generally also been found that broad or universal banks did not systematically abuse their powers (Ang and Richardson 1994; Kroszner and Rajan 1994). Securities underwritten by commercial banks' affiliates, for example, had higher prices (lower yields) than comparable securities underwritten by investment banks (Puri 1996). Other evidence for the pre-Glass-Steagall suggested to the contrary that greater banking powers involved gains for corporations. The presence of bank directors on corporate boards, for example, helped these firms in relieving their financing constraints (Ramirez 1995). More recent evidence on US banks' involvement in corporate governance is Kroszner and Strahan (2001). They report that US firms are more likely to borrow from their connected banks, i.e., banks which are indirectly involved in the firms' corporate governance through board linkages, but do so on terms similar to those of unconnected firms.

More recent evidence on US banks' role in the simultaneous lending and securities activities, although it happened in an environment with restrictions, does not question these findings. Gande, Puri, Saunders and Walter (1997 and 1999) examine the pricing of debt securities underwritten by subsidiaries of U.S. commercial bank holding companies relative to those underwritten by investment houses. They find no evidence of conflicts of interest in situations like when the purpose of the bank underwriting is to repay existing bank debt. They rather find evidence that banks that underwrite debt securities of firms to which they also lend provide a net certification effect. They also find that banks bring a relatively larger proportion of smaller sized issues to the market than investment houses do, suggesting bank underwriting is on net beneficial to smaller firms. For Israeli Initial Public Offering (IPO) in the 1990s, Ber, Yadeh, and Yosha (2000) find similar evidence in case of equity underwritings. Universal banks in Israel use their superior information regarding client firms to float the stock of the cherries, not the lemons as the post-issue accounting performance is higher than average. This suggests no conflicts of interest.

Conflicts of interest of relevance to the issue of integrated banking refer only to those arising from the potential provision of banking, securities and/or insurance related services by one financial institution. As noted, conflict of interest can also arise among similar type of services, not just between banking and securities activities. Investment banks, for example, may face a conflict between their research and underwriting activities, or between their brokerage and underwriting activities. Some of the conflicts of interest that arise when commercial banks are active in the securities business thus already exist in the normal banking business, and vice versa.

The conflicts within the securities business have received considerable attention recently, especially in the US. These conflicts are not the subject of this paper. It is worth noting, however, that conflict of interest are more important in agent activities and less important when the financial institution acts on its own account. When a financial institution acts only as a broker or as an underwriter, it has, besides its reputation and any legal liability, no direct financial exposure if the security was not properly priced or if the offering contained misleading information about the firm's prospects. When the financial institution is also acting as a bank itself, however, it will remain exposed through its lending operations even if sells all securities of the firm and the pricing were not right. As such, conflicts between banking and securities activities may be less than conflicts among securities market activities that only involve agent functions, such as underwriting.

This is not to say that there have not been cases of misuse of information banks have collected in their lending activities for their investment banking activities. In the case of Israel, Ber, Yafeh, and Yosha (2001) find, for example, that bank managed funds pay too much for bank underwritten IPOs at the expense of the investors in the funds. More generally, there can be conflict of interest in the combination of bank lending, underwriting, and fund management. In the US, there have been recently some suits against commercial banks not protecting the interest of firm' shareholders when underwriting new securities (e.g., in case of Enron). Although some of the cases are still in judicial process, it does not appear that there has been a systematic abuse of conflicts between commercial and investment banking activities.

Nevertheless, conflicts of interest can be misused. The ability to exploit conflicts will often be dealt with by private standards adopted voluntarily by financial institutions—such as information-sharing rules between departments of an integrated bank—or promulgated by self-regulatory associations—such as rules on behavior of certified financial analysts. Increasingly, many financial institutions have been tightening their internal procedures in these areas in response to market forces. In general, conflicts tend to be more important in countries where disclosure rules are weak, information on banks' activities is limited, and where competition is limited and supervision is weak. In these circumstances, conflicts can be further restricted by legal constraints—such as disclosure requirements to be met in the issuance and distribution of securities or separation of some activities in subsidiaries. Since at the same time, IFSP can offer more gains in informationally weaker countries, the preferred best balance between self-regulation and government restrictions can not easily be identified and will vary by institutional characteristics of the country.

Safety and Soundness and the Safety Net. While the combination of insurance, securities and commercial banking activities can increase the possibilities of risk diversification, it also increases the scope for bank managers to increase and shift risks, thereby raising the probability of bank failure (Saunders 1994 and Boyd, Chang and Smith 1998). While this has happened—in emerging markets as well as in developed countries (e.g., Barings), empirical evidence does not confirm as a general proposition that broad or universal banks fail more frequently than specialized banks (White 1986). As noted, there is actual evidence at the individual financial institution's level that the combination of financial activities reduces overall risks.¹³

Nevertheless, as “banks” evolve into large financial conglomerates, combining deposit-taking functions with insurance, investment banking, asset and pension fund management, and other financial intermediation functions, safeguards can be (more) necessary to avoid the transfer of explicit and implicit deposit insurance subsidies from the banking part of the institution to the securities and other parts (Kane 1996 and Schwartz 1992). These safeguards can take the form of market value accounting, timely monitoring and disclosure, more risk-sensitive capital requirements, firewalls between different type of operations, risk-based pricing of deposit insurance and prompt corrective actions, including the closure of insolvent banks. In many ways, these safeguards are not different from those being applied to normal banking operations, but may need to be stricter and closer enforced.

Monitoring and Supervision. Supervision of commercial banks, insurance companies and securities entities involves different objectives. Supervision of commercial banks aims to protect the net worth of the entity, and thus the rights of creditors, particularly depositors, as the bank is intermediating third-party money. The objective of supervision of insurance companies is similar to that of banks, i.e., to protect the net worth of the entity. For securities firms, regulators’ objective is mainly consumer protection, i.e., avoiding misuses arising from the agent-type relationships typical in securities markets. The combination of insurance, securities and commercial banking activities can make supervision by regulators and monitoring by the market more difficult as the insurance and securities businesses might have an impact on the banking business while the two activities can not easily be monitored separately.

More generally, recent developments may have made it more difficult for supervisors to monitor financial service providers.¹⁴ In this respect, IFSP can lead to more risks, particularly when supervisory agencies do not coordinate closely. At the same time, when IFSP leads to closer cooperation among regulators, including possibly the merging of supervisory activities in one single supervisory authority, gains may arise from combining financial services activities (see further Claessens and Klingebiel 2002).

Unrestricted financial activities may also lead to the formation of large and complex entities that are extraordinarily difficult to monitor.¹⁵ Recent studies on the effects of consolidation among large, financial conglomerates have analyzed, among others, this risk (G-10 report, 2001). The conclusions were that the potential effects of consolidation on the risk of individual institutions are mixed, the net result is impossible to generalize, and thus a case by case assessment is required. However, the report did find that consolidation increases the probability that a workout or wind-down of an impaired large and complex banking organization would be difficult and could be disorderly. This difficult workout need not be a concern in itself from a public policy perspective, except that it may lead to too much access to the safety net. Also, ever larger institutions may become so politically and economically powerful that they become “too big to discipline” or “too big to disappear.” As such, there are risks of (large) financial conglomerates.¹⁶

Competition, innovation and economic concentration. An IFSP-based financial system may lead to greater market concentration, in part as it raises the optimal scale of financial institutions and as it allows for greater linkages among

financial and non-financial institutions. Moving to IFSP thus has the potential to reduce competition. As such, theoretical arguments can be made why large financial conglomerates may reduce competition and hence the efficiency in the financial sector. There can also be dynamic effects of (lack of) separation on competition. One argument used to justify the separation of commercial from investment banking in the U.S. has been that it fosters competition and leads to more innovation within business lines. The separation creates a need among investment banks to develop more specialized services, whereas universal banks may be less under pressure to do so as they have more secure profits. Boot and Thakor (1997), who analyze the relationship between financial innovation and scope, argue that specialized systems may foster more innovation.

At the same time, as noted, there is little logic from a business perspective to separate the provision of financial services among different categories. Separation may rather stifle innovation in how to provide financial services in an integrated manner through more efficient marketing and production, which would lead to economic gains through reduced cost and greater efficiency. The combination of different financial services in one organization may also be very useful in countries undertaking financial reform, particularly with respects to insurance and pension or, more broadly, social security systems. The combination can transpose know-how from banking to insurance and investment management to find appropriate solutions for pension and social security problems. For countries building up new systems, allowing existing banks to expand into insurance and pension activities may also be a quicker way to build up these segments of financial services industries. Since in general government intervention in the form of forced separation of business activities

is not assumed to lead to greater innovation, it is reasonable to argue that IFSP leads to as much innovation in the overall production and marketing of financial services as under separation.

Available empirical evidence on the effects of IFSP on competition has largely been limited to studying universal banking and the evidence is mixed. A study of the German universal banking system in the pre-World War I period in comparison with its American and British counterparts found that the combination of commercial and investment banking services did not influence banking industry concentration, levels of market power, or financial performance of banks (Fohlin 2000). In terms of concentration, the German banking system was very similar to the UK's specialized commercial banking sector, and neither system was extremely concentrated, suggesting universality does not necessarily or uniquely propagate concentration. On average, the analysis found that German universal banks behaved no less competitively than their American counterparts in the provision of loan services, and little evidence of deviation from competitive pricing was found in either country. International differences in bank returns on equity and on assets, although large in individual years, were only slight over extended periods. At the same time, universality was not associated with superior profitability, whether due to efficiency gains (economies of scope) or monopoly power. As such, universal banking was at worst neutral to competition and perhaps beneficial.

One of the few studies on the effects of greater scope of activities on competition in insurance service is Carow (2001). He finds that rulings by the US Office of the Controller of the Currency and the Supreme Court removing barriers to

entry by banks into the insurance industry reduced the market value of the insurance industry, while it did not change the value of banks. This suggests that the entry of banks increased competition in the insurance industry and made the industry more contestable. Empirical studies on the effects of integrated or separated financial system on innovation are rare, although casual observations would suggest that a separate system can be more innovative in the design of specific financial products and an integrated system can be more innovative in the overall production and marketing of financial services.

A concern related to competition has been the concentration of economic power that may come along with financial institutions having a wide scope of activities, including owning non-financial institutions. This has been a highly charged, political economy issue, and some countries care more about 'excessive' concentration than others. This issue relates probably more to the concentration of economic power in general, including that of non-financial institutions through financial institutions, the degree of competition, as well as the difficulty to supervise large financial institutions, rather than to the particular financial services provision model adopted.

In practice, the alleged concentration and abuse of power were nevertheless the most important aspects motivating the separation of banking activities in the U.S. during the 1930s. Recent studies reviewing this period (Rajan and Kroszner, 1994 and 1997, Benston 1994) suggest, however, that there was not much abuse and that the securities activities of commercial banks bore little responsibility for the banking problems of the Great Depression. Some other studies have actually argued that the

universal banking nature can help overall economic development. Motivated by the experiences with 19th century continental European industrialization, particularly in Belgium, Germany and Italy, Da Rin and Hellman (2000) develop a model where banks can catalyze industrialization by acting as coordinators. This requires them to be sufficiently large to be able to mobilize a critical mass of financial resources and to possess sufficient market power to make profits from coordination. Being a universal bank can help in both respects as it increases the optimal scale of operations, allows banks to reap profits from possible equity issuance, and makes coordination more generally easier. They argue that the lack of industrialization in Russia in the late 1800s, Spain and pre-1890s Italy is consistent with this theory in the sense that the necessary conditions were not satisfied then in these countries. In case of Russia, the banking system was not very concentrated and the state kept limiting the growth of new banks. In case of Spain, banks were curtailed in their investment in manufacturing firms, whereas in Italy there were too many, small banks.

Cross-country empirical studies. Most studies referred to so far relate to micro, financial institution-specific analyses, testing specific hypotheses, and mostly conducted for one or a relatively small set of countries that are most often also at similar levels of development (e.g., a sample of European countries or a comparison between the US, Japan and Germany). As such, they can not analyze the role of country circumstances in determining the benefits and costs of different arrangements. Typically, they neither analyze the effects of different arrangements on overall financial sector development and the non-financial sector. As such, they do not provide a more general analysis of the costs and benefits for a broad sample of countries.

An important cross-country study addressing this deficiency is Barth, Caprio and Levine 2001a. They analyze empirically, among others, the cost and benefits of different allowable scope of activities for over 90 countries. As reported above, for each of these countries, they document the regulatory restrictions in place in 1999 (or around that time) on the ability of commercial banks to engage in securities, insurance, and real estate activities. They then study the relationship of banking powers with the following measures: (i) the level of banking sector development, (ii) net interest margins, (iii) the overhead costs, (iv) non-performing loans, and (v) the occurrence of a banking crisis. They find that restricting commercial bank activities is negatively associated with bank performance, measures (i) through (iv), as compared to when banks can diversify into other financial activities, especially securities markets activities. They also find that countries with greater regulatory restrictions on the securities activities of commercial banks have a substantially higher probability of suffering a major banking crisis. Their study thus suggests that lack of regulatory barriers, i.e., more IFSP, can lead to financial sector stability.

These results provide a comprehensive, positive assessment of broad banking powers in terms of financial sector development, efficiency and stability. Arguably, a generally stronger regulation and supervision framework in a country may justify less need for the countervailing positive effects from restricting banking sector activities. A positive relationship between regulatory restrictions and financial crises could thus be due to the fact that countries with weaker supervisory systems compensate by imposing more restrictions on bank activities. But, the empirical results suggest this is not the case, as the analysis controls for official supervisory procedures, capital

regulations, regulations on competition, and the moral hazard engendered by generous deposit insurance schemes. Specifically, Barth et al. (2001a) “find no improvements in bank performance or stability from restrictions on bank activities in economies that offer more generous deposit insurance, have weak official supervision, ineffective incentives for private monitoring or that lack stringent capital standards.” Furthermore, their findings are not due to reverse causality or potential simultaneity, as when greater financial sector development or more financial stability leads countries to adopt more liberal rules.

The results of Barth et al. 2001a on the benefits of less restrictions on banking activities in terms of financial sector efficiency are confirmed by Demirgüç-Kunt, Laeven and Levine (2002), whom study the effect of bank concentration on individual bank performance. Using bank level data for 77 countries (some 1500 banks), they find, among others, that fewer regulatory restrictions are associated with lower net interest margins. Although not a perfect measure of bank efficiency, the result nevertheless suggests that banks can produce financial services at lower costs when they are more able to fully exploit their economies of scope.

Cross-country evidence also supports the benefits of fewer restrictions for firm access. One study is Beck, Demirgüç-Kunt and Maksimovic (2002a). Using data on the financing patterns of relatively small firms in 48 countries, they find that more restrictions on the scope of commercial banking activities increase the negative impact of a concentrated banking system on the financing constraints for small firms. Another study on firm financing patterns is Beck, Demirgüç-Kunt and Maksimovic (2002b) who find that in countries that restrict bank activities less, firms are more

likely to issue equity. To the extent that increased use of equity lowers firms' leverage and involves a wider pool of investors, broader bank powers can help reduce firm and financial sector riskiness, and more generally improve the allocation of resources through improved monitoring.

These cross-country results suggest that any policy of restricting bank powers does not produce positive results in particular institutional or policy environments, that is, it is not the case that restrictions compensate for some institutional weaknesses or market failures. Rather, Barth et al. (2001a) find that more restrictive regimes often arise due to political economy factors. In their words, governments may regulate to support political constituencies, not to correct for institutional weaknesses or market failures. They find empirically that government integrity is lower (corruption higher) in countries which restrict banks' activities more as well as where the government more generally plays a larger role in the financial sector. As such, political economy rather than economic reasons most likely cause developing countries to restrict more.

In terms of the effects of banking concentration possibly arising from allowing IFSP, Cetorelli and Gambera (2001) show in a cross-country study that banking sector concentration promotes the growth of industries that depend heavily on external finance. They also find, however, that it does exert a depressing effect on overall economic growth. Demirgüç-Kunt, Laeven and Levine (2002) find that bank concentration has a negative and significant effect on the efficiency of the banking system, except in rich countries with developed financial systems and significant economic freedoms. Since empirically there is a negative relationship between restrictions on banking activities and banking concentration (i.e., those countries that

restrict less tend have more concentrated banking systems), there might be a tradeoff from allowing a wider scope of bank activities between financial stability and access on one hand and growth and efficiency on the other hand.

In summary, the cross-country studies find either that there is little relationship between regulatory restrictions on banking powers and overall financial development and industrial competition, or that restrictions hinder banking system performance and access to financial services by firms. Cross-country studies are quite clear in identifying that restrictions increase the risk of a financial crisis. As such, the studies suggest that no restrictions on bank activities may be the most preferred. Studies suggest some benefits of some degree of banking system concentration, but also some negative impact on bank efficiency and growth. Since fewer restrictions on bank activities can lead to more concentration, it will be important to balance relaxing restrictions with lowering barriers to entry.

The Corporate Structure of Banking Organizations. The discussion so far has not considered the organization model permitted for universal banking. Whether the potential benefits can be realized by financial institutions and the degree to which any costs may arise, however, depends on the organizational model permitted for integrated banking. The organizational structure may matter as well for financial development and performance and bank stability. Annex 3 provides some considerations for the organizational models often used.

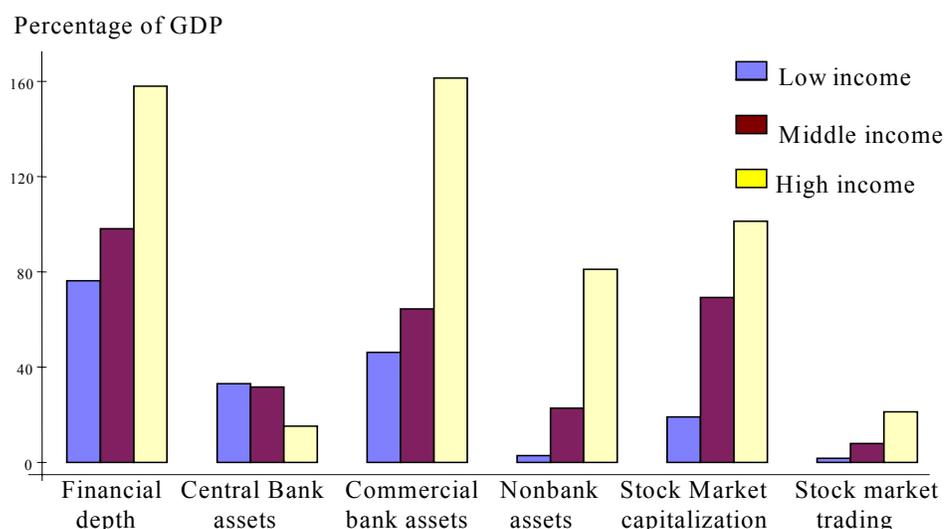
5. Financial conglomerates in emerging markets

The role of banks and securities markets in emerging markets. While many of the global trends towards integrated financial services provision have also affected emerging markets, these economies still differ in many ways from the developed countries, resembling more the situation of currently developed countries a century ago. For one, the relative importance of banking, securities and insurance markets in emerging markets still differs from that in more developed countries. As has often been noted, most comprehensively in Demirgüç-Kunt and Levine (2001), banks tend to be more important in developing countries. On average, the size of the banking system in low-income countries is double that of stock markets (Figure 1). There are exceptions, such as Malaysia where both banking and securities markets are quite large, at least prior to the 1997 crisis, but in general banks tend to dominate financial intermediation in developing countries, with securities markets and insurance markets much smaller and less active.

This relative importance reflects a commonality in the process of financial development. Low-income countries are characterized by reliance on informal finance, with lending for small investments secured through a network of social relationships and peer-group monitoring, often linked to trading and agriculture and mainly involves advances for trade from one firm to another. Foreign banks may play a large role in financing foreign trade, but much less so in domestic trade. As the economy develops and urbanizes, some of these networks may formalize themselves into lending associations or banks. This process of more formal financial intermediation is often accelerated when there are major new developments in the

economy, for example, opening up of new trading opportunities or new industrial discoveries, such as during the industrial revolution in Europe, which generate concentrated wealth. During most of this process, however, banks will dominate financial intermediation.

Figure 1: Financial Structure in Low-, Middle-, and High-Income Economies



Source: Levine, 1997.

Notes: The data of Figure 1 are for 12 low-income countries, 22 middle-income countries and 14 high-income countries. Financial depth is measured by currency held outside financial institutions plus demand deposits and interest-bearing liabilities of banks and nonbank financial institutions (M3 money supply). Nonbank assets include insurance companies, pension funds, mutual funds, brokerage houses, and investment banks. Data refer to the year 1990.

As countries develop, financial intermediation deepens, banks grow relative to central banks in allocating credit. Next, nonbanks rise in importance and insurance and pension services will be introduced. Capital markets will only come to play a role in the later stages of development, when legal systems and reputational capital are

established and people have the trust to trade pieces of papers which just represent promises to pay. While progression from one stage to another stage can be hastened, it is not clear that actual stages can be skipped. For example, it has seldom been the case that countries have been able to develop their equity markets without having reasonably developed short-term money markets, for if the infrastructure for trading relatively low-risk instruments is lacking, riskier products, such as long-term bonds and equity, are generally absent.¹⁷ And even among the most developed countries, capital markets are still not the most important source of financing for the corporate sector, with banks being more important in continental Europe and Japan, for example.

Financial conglomerates in emerging markets. The general development process and the differences in the relative importance of the bank and non-bank services—the larger role of banking services and the smaller role of insurance, pensions and securities markets—would suggest that the issue of IFSP is of less relevance for emerging markets. It would also suggest there are fewer reasons for having financial conglomerates in emerging markets. Yet, when defined broadly, given countries' level of general and financial sector development, “financial conglomerates” are actually quite common in emerging markets, the more so when taking into account the restrictions typically imposed on bank activities. This relative common presence is to some extent through the direct provision of different types of financial services by a single financial institution, in spite of greater formal restrictions. More often, though, “financial conglomerates” exist indirectly through common ownership of different types of financial institutions by a single non-financial entity or group of individuals (“family”). Also, much of firm financing in

emerging markets comes from other firms and financial institutions within the same business groups, i.e., groups act as (financial) conglomerates, affecting the costs and benefits of IFSP provided by financial institutions external to the group. I discuss each aspect in turn.

The allowable scope in emerging markets and direct IFSP. There is a clear tendency for the restrictiveness of the regime for banking activities to decline as one moves from lower-income to higher income countries, with regimes on average less liberal in developing countries. The average restrictiveness index for securities markets activities reported by Barth et al. (2001b) is 2.04 for developing countries, compared to 1.37 for developed countries; and for insurance activities the index is 2.90 for developing countries compared to 2.22 for developed countries.¹⁸

While the direct provision of multiple services in one financial institution has more formal limits in lower-income countries, the combination of commercial and investment banks is nevertheless quite common in many emerging markets. In most transition economies, except China, the universal banking model has been adopted, allowing securities markets activities to be conducted directly in the bank. The average indicator of restrictiveness for securities activities for the region Less-developed Europe and Central Asia (mainly transition economies) does not differ much from that for the OECD-countries. Similarly, the Middle East and North Africa region is equally restrictive as the OECD countries on average are. The South Asia and Latin America regions are somewhat more restrictive than OECD countries are, as is Sub-Saharan Africa. The most restrictive region is the East Asia and the Pacific region, with an average restrictiveness index of 2.41 (see Annex Table 3).

Although there are somewhat more restrictions, especially in Asia and low-income countries Africa, financial conglomerates nevertheless dominate in most emerging markets. In countries like Brazil, Mexico, South Africa and Poland large financial conglomerates represent the bulk of the financial services industries. Banks in many Latin American countries are the most important managers and distributors of mutual funds, own large pension funds and are becoming more involved in insurance activities. In some countries, the importance of financial conglomerates has been long-standing, in others, it has come about more recently. In Brazil, the links between banking, insurance and asset management have been in place for many years, with important financial conglomerates such as Banco do Brasil, Bradesco and Banco Itau. In other Latin American countries, the advent of financial conglomerates has been helped by the growth in (mandatory) pension funds over the past few years. In Eastern Europe, the low quality of information and the need for banks' involvement in enterprise restructuring made the universal banking initially more attractive. As most countries in the region have also adopted mandatory pension systems and as the demand for non-bank services has been rising, East European banks have been widening their product offerings, including pension and insurance services. In Asia, banks have been the least active in IFSP, although in more recent years they have been widening their scope as well, in part in response to the more liberal rules, including the permission to form holding companies in Korea and the freeing of restrictions in Malaysia.

Given the low role of securities markets, nevertheless, non-bank services are still not the largest share of income for these financial conglomerates. Fee income is

much less important in developing countries than in developed countries. Part of the low role of fee income relates to the more restrictive rules: the relationship between non-fee income (as a share of bank assets) and the severity of activity restrictions is then also negative (a correlation of -0.290, as reported by Demirgüç-Kunt, Laeven and Levine 2002). Nevertheless, as a group, non-traditional banking activities are increasing as a source of income; fees accounted for 1.18 percentage points of banking system assets in 1999 in developing countries, up from 1 percentage points over the whole 1995-99 period. Still, this is much below higher-income countries and overall there are probably relatively fewer formal financial conglomerates in developing countries, especially in low-income countries, than in developed countries.¹⁹

Indirect IFSP. If I define a financial conglomerate in terms of common ownership of financial institutions, however, financial conglomerates are more important in emerging markets. As a start, it is important to realize that the structure of ownership of financial and non-financial institutions in emerging markets is quite different from that typically found in developed countries, at least different from that in the US. A single individual or family closely controls many financial and non-financial corporations around the world (La Porta et al. 1998, Claessens et al. 2000). This is both through direct and indirect ownership, including cross-ownership, pyramiding structures, dual-class voting shares and other mechanisms separating control from ownership. Many commercial banks in emerging markets have started as a family-owned business and remained closely controlled even when having grown. Importantly for the analysis of financial conglomerates, in emerging markets these owners often control not only commercial banks but also other types of financial

institutions. The few wealthy families controlling the commercial banks in Thailand, for example, also control some finance companies and investment banks.

As such, common control opens possibilities for some joint provision of different types financial services by the combined entities in a group. For example, a bank borrower which accesses for the first time the capital markets may receive services from an indirectly affiliated investment bank. There are substantial transaction costs and limits to these forms of IFSP, however, as in the reduced ability to share information across financial institutions. This may explain at the micro-level why cross-country studies find that restrictions add to the cost of providing financial services. It may also further reduce transparency and risks to the financial system as a whole. As such, these joint ownership structures are not attractive. Nevertheless, they do constitute a form of IFSP, which may reduce the demand for formal financial conglomerates.

The role of groups. A third aspect to consider is that in general the links among financial institutions and between financial and non-financial corporations are much greater in emerging markets. Most of this happens through business groups with common direct and indirect ownership and most importantly common control. As documented by Khanna and Yafeh, 2002, Lins and Servaes, 2002, Claessens et al. 2002 and others, business groups are very common in developing countries. About 60% of large, public-listed firms in East Asia, for example, belong to a group. Many of these groups are not just industrial conglomerates, but also have a financial institution in the group structure.

The role of the financial institution is, however, different from that found in many developed countries (except for the US). In most developed countries when present in a group, the financial institution is most often the apex institution through which the non-financial corporations are being controlled. In continental Europe the financial institution is typically a bank, whereas in Japan it is typical an insurance company. In emerging markets, however, the financial institution in a group typically functions not as vehicle to exercise control, but rather as the group-bank, facilitating resource sharing. The distinguishing character of a group more generally, is that the affiliated non-financial and financial corporations share to a greater extent resources among each other. For the non-financial corporations, the resource sharing happens through intra-company loans and investments and more generally through intra-group transactions at terms more favorable compared to third-party transactions. As such, the commonality of group structures may mean that for companies within the group there is in effect IFSP, which may affect the demand and supply for outside integrated services.

Costs and benefits of IFSP in emerging markets. In spite of greater restrictions on banks' activities and less importance of securities markets, IFSP is relatively common in developing countries. Furthermore, through joint ownership and group structures, IFSP-type arrangements, including close bank-commerce links, are quite prevalent in emerging markets, perhaps more than in many developed countries. This raises a few questions: what are the specific costs and benefits of IFSP in emerging markets, are the restrictions on activities in emerging markets more useful or more costly, and what other policy implications follow?²⁰

There are very few studies that analyze the costs and benefits of universal banking specifically for emerging markets and there are even fewer studies about the combination of banking and insurance or other forms of IFSP. Most relevant is the work reviewed above on the role of universal banks in the late 1800s and early 1900s in Europe, the U.S. and Japan as the circumstances of those countries then resemble many emerging markets today. The discussion early on in the financial sector reform process of transition economies is illustrative as it was very much based on these experiences (see, for example, Brainard 1991). Many argued that the conditions in transition economies made the universal banking model more attractive than having separate commercial and investment banks. Allowing banks to engage in a variety of financial activities and to own shares in enterprises exploits banks' informational advantages, which were at a premium in the high-risk, limited information environment of many transition economies. Especially early on in the transition, banks also had to play a large role in enterprise restructuring, which was further facilitated by being universal banks. Combined with some need for banks to act as coordinating agencies and to concentrate scarce financial skills, and in that way facilitate the process of change, universal banking was arguably the best model. Most transition economies in fact opted for some type of universal banking model.

Similar arguments for IFSP apply to many other emerging markets still today where information asymmetries are high, skills are limited and in need of concentration, and some coordination needs exist in terms of large projects. This model has its risks in emerging markets, however, especially given the generally weak financial sector regulation and supervision. Substantial cross-holdings between banks, investment and pension funds, and enterprises in many emerging markets have led

conflicts of interests to be systematically abused. In other countries, universal banks have misused their powers, including by allocating shares to own-managed mutual funds at too high prices. Thus exposure guidelines, which limit individual investments to a certain fraction of assets or capital, disclosure standards and other measures aimed at addressing conflicts of interest or risk need to be strictly enforced for banks as well as financial-industrial groups, especially for lending to managers and affiliated enterprises. In addition, there can be a greater need to capitalize some activities separately in order to protect depositors. Furthermore, there may be greater risks from too much concentration in the financial sector, particular if banking and insurance activities are allowed to combine. Together these institutions will control the bulk of savings in many emerging markets. As, in the presence of economies of scope, the combination may reduce potential competition, especially in small markets. The risks nevertheless mainly arise from the common ownership and control of different type of financial institutions and financial spillovers. The arguments to separate the distribution of different types of financial products in emerging markets from a risk point of view are much less strong.

While one can try to use regulations to mitigate risks, one has to remain cognizant of the limits to supervision, especially in emerging markets. Typically, abuse arises only in part from weaknesses in regulation and more often from the very limited enforcement of supervision in these countries. Better supervision is an obvious remedy, but often not very feasible in light of human skills shortages and low pay, restricted by overall wage public sector wage scales. Furthermore, greater supervisory powers can be counterproductive in the absence of check and balances in the system (Barth et al., 2001a). Experiences suggest that risks associated with

financial conglomerates usually rather come from two factors: an excessive role of the government, including central bank and ministries, directly and indirectly in banks and financial groups; and a lack of competition and contestability in the financial and real sectors. Financial conglomerates have been harmful mostly when the financial system was heavily controlled, for example, through controlled interest rates or high entry barriers. Nevertheless, country circumstances could call for differentiated approaches where the scope of activities is widened as the institutional framework is strengthened and financial markets develop.

The role of groups in emerging markets. The presence of groups does affect the relative gains of moving to IFSP in emerging markets. The use of internal markets in emerging markets to allocate financial resources can add value by providing collateral across firms, overcoming information asymmetries and contracting problems, etc., which is particularly valuable when external financial markets are not well developed (Khanna and Palepu 2000). At the same time, because of their reduced transparency and complicated ownership and control structures, groups can have severe corporate governance problems, or at least aggravate corporate governance problems which typically are already large in emerging markets (Claessens et al. 2002). Groups may also stymie the development of securities markets.

The benefits and costs from groups depend on the country's institutional context. It may be that the benefits of internal markets are the greatest in those countries in which the impact of corporate governance problems is also the most severe. That is, while in countries with the least developed external financial markets

the potential beneficial role of internal markets may be the greatest, it is likely that the ability to mitigate any corporate governance problems associated with group structures is also the weakest in these countries. This suggests that reforms focussing on reducing corporate governance problems may enhance the efficiency of the use of internal markets. At the same time, such reforms will diminish the need for internal markets as they encourage the development of external financial markets. The fact that groups diminish in importance as countries develop suggests that the gains from better external markets are stronger than the benefits from internal markets. This suggests that emerging markets are better off promoting formal relationships—in the form of external financial markets, banks and securities markets, including formal financial conglomerates—rather than relying on internal markets with many corporate governance problems. The specific reforms necessary will depend on countries' current institutional frameworks.

6. Conclusions

IFSP can lead to gains for the financial sector, firm and economy in the form of a greater supply of better quality financial services, reduced financial intermediation costs, and lower risks. These gains are observed at the level of the financial institution, the firm, the household and the whole economy. IFSP may, however, lead to risks. It can increase opportunities for conflicts of interest and risk-taking behavior by financial institutions at the ultimate cost of taxpayers through a publicly provided financial safety net. It can make financial institutions too complex to monitor by markets and supervisors. And it can reduce competition as it increases

the concentration in the financial sector and make financial conglomerates politically too important to close or ignore. These possible risks associated with IFSP do impose some specific demands on financial sector regulation and supervision.

For emerging markets, the available evidence suggests that the gains from IFSP outweigh the risks, possibly even more so as human resources are scarce, information asymmetries greater and coordination needs still significant. Key requirements to maximize the gains are effective competition, that is open and contestable financial systems, and strict enforcement of a number of key measures to prevent leakage from any publicly provided safety net.

References

- Allen, Franklin, and Douglas Gale, 2000, *Comparing Financial Systems*, MIT Press, Cambridge, MA.
- Ang, J. S. and T. Richardson. 1994. The Underpricing Experience of Commercial Bank Affiliates prior to the Glass-Steagall Act: A Re-examination of Evidence for Passage of the Act. *Journal of Banking and Finance* 18, pp. 351-95.
- Barth, James R. Daniel Nolle, and Tara Rice, 1997, Commercial banking structure, regulation, and performance: an international comparison, Comptroller of the Currency, Economics Working paper 97-6, Washington.
- Barth, James R., Gerard Caprio and Ross Levine. 2001a. Banking system Around the Globe: Do Regulation and Ownership Affect Performance And Stability?, in Frederic S. Mishkin, Editor, *Prudential Supervision; What Works and What Doesn't*, University of Chicago Press.
- Barth, James R., Gerard Caprio and Ross Levine. 2001b. The Regulation and Supervision of Banks Around the World: A New Database. In Robert E. Litan and Richard Herring, Editors, *Integrating Emerging Markets in the Global Financial System*, Brookings/Wharton Papers on Financial Services, Brookings Institution Press, Washington, D.C.
- Beck, Thorsten, Asli Demirgüç-Kunt and Vojislav Maksimovic, 2002a, Bank Competition, Financing Constraints And Access to Credit Firm, World Bank Mimeo.

- Beck, Thorsten, Asli Demirgüç-Kunt and Vojislav Maksimovic, 2002b, Financing Patterns around the World: The Role of Institutions, World Bank Mimeo.
- Ber, Hedva, Yishay Yafeh, and Oved Yosha, 2001, Conflict of interest in Universal Banking: Bank Lending, Stock Underwriting and Fund Management, *Journal of Monetary Economics*, 47, No. 1:189-218, February
- Benston, G. J. 1990. *The Separation of Commercial and Investing Banking: The Glass-Steagall Act Revisited and Reconsidered*, New York, Oxford University Press.
- Berger, A. N., G. A. Hanweck and D. B. Humphrey, 1987. Competitive viability in banking. Scale, Scope, and Product Mix Economies, *Journal of Monetary Economics*, December, 501-520.
- _____, and Udell, G.F. 1996, Universal banking and the future of small business lending, in I. Walter and A. Saunders (eds.), *Universal Banking: Financial System Design Reconsidered*, Chicago, Irwin, pp. 559-627.
- Bodie, Z., and Merton, R. C., 2000 *Finance*, New Jersey: Prentice-Hall.
- Boot, Arnoud, and AnjanV. Thakor, 1997, Banking Scope and Financial Innovation, *The Review of Financial Studies*, 10 (4), 1099-1131.
- Boyd, John H., Chun Chang and Bruce D. Smith. 1998. Moral Hazard under Commercial and Universal Banking. *Journal of Money, Credit, and Banking* 30, No. 3, August.

- Brainard, Lawrence J., 1991, Eastern Europe: Creating a Capital Market, in Richard O'Brien and Sarah Hewin (eds.), *Finance and the International Economy*, No. 4, The AMEX Bank Review Prize Essays.
- Brewer, E. III, D. Fortier and C. Pavel. 1989. Bank Risk from Nonbank Activities. *Journal of International Securities Markets*: 3, pp. 199-210.
- Briault, Clive, 1999, The Rationale for a Single National Financial Services Regulator, Occasional Paper Series 2, Financial Services Authority, http://www.fsa.gov.uk/pdf/policy/fsa_op02.pdf.
- Bueschgen, Hans E. 1970. Universalbanken oder Spezialbanken als ordnungspolitische Alternative fuer das Bankgewerbe der Bundesrepublik Deutschland unter besonderer Beruecksichtigung der Sammlung und Verwendung von Kapital, Gutachten.
- Carow, Kenneth, A. 2001, The Wealth Effects of Allowing Bank Entry in the Insurance Industry, *Journal of Risk and Insurance*, Vol. 86: 1. March.
- Carow, Kenneth, A. 2002, Citicorp - Travelers Group Merger: Challenging Barriers Between Banking and Insurance, mimeo, Indiana University, *Journal of Banking and Finance*, forthcoming
- Claessens, Stijn, Daniela Klingebiel and Thomas Glaessner, 2002, Electronic Finance: Reshaping the Financial Landscape Around the World, *Journal of Financial Services Research*, 22:1/2, 29-61.

- Claessens, Stijn, Daniela Klingebiel and Sergio Schmukler, 2002, The Future of Stock Exchanges in Emerging Markets: Evolution and Prospects, Robert E. Litan and Richard Herring (Eds.), *Brookings-Wharton Papers on Financial Services 2002*, The Brookings Institution, Washington, D.C., 167-212.
- Clark, Jeffrey A. 1988, Economies of Scale and Scope at Depository Financial Institutions: Review of the literature, *Economic Review* of the Federal Reserve Bank of Kansas City. 16-33, September/October.
- Da Rin, Marco and Thomas Hellman, Banks as Catalysts for Industrialization, 2000, London School Of Economics and Political Science. LSE Financial Markets Research Centre. Discussion Paper (U.K.); No. 343:1-[42].
- Demirgüç-Kunt, Asli, and Ross Levine (Eds), 2001, *Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development*, MIT Press, Cambridge, MA.
- Demirgüç-Kunt, Asli, Luc Laeven and Ross Levine, 2002, The Impact of Bank Concentration and Regulations on Bank Efficiency, mimeo, World Bank.
- Easterly, William, Roumeen Islam and Joseph E. Stiglitz. 2000. Shaken and Stirred: Explaining Growth Volatility. *Annual World Bank Conference on Development Economics*. 191-211.
- Fohlin, Caroline, 1998, Relationship Banking, Liquidity and Investment in German Industrialization, *Journal of Finance*, 53, 1737-58.
- Fohlin, Caroline, 2000, Banking Structure, Competition, and Performance: Does Universality Matter?, mimeo, California Institute of Technology, October

- Gande, Amar, Manju Puri, Anthony Sanders, and Ingo Walter, 1997, Banking Underwriting of Debt securities: Modern Evidence, *Review of Financial Studies*, 10, 1175-1201.
- Gande, Amar, Manju Puri, Anthony Sanders, and Ingo Walter, 1999, Bank Entry, Competition and the Markets for Corporate Securities Underwriting, *Journal of Financial Economics*, 54, No. 2:165-95, October.
- Group of Ten, Report on Consolidation in the Financial Sector, Ferguson Report, January 2001, IMF, BIS, and OECD, available at <http://www.bis.org/publ/gten05wp.pdf>
- Gorton, Gary, and Frank A Schmid, 2000 Universal Banking and the Performance of German Firms, *Journal of Financial Economics*, 58:1-2, (October/November), 29-80.
- Hunter, W. C., S. G. Timme, and W. K. Yang. 1990. An Examination of Cost Subadditivity and Multiproduct Production in Large U.S. Banks. *Journal of Money, Credit, and Banking*, November, 504-525.
- IMF, 2001, *Capital Markets Report 2001*, Chapter V Financial Sector Consolidation in Emerging Markets, Washington, D.C.
- Institute of International Bankers, 2002, *Global Survey*, Washington, D.C. at www.IIB.org
- John, Kose, Teresa A. John and Anthony Saunders. 1994. Universal Banking and Firm Risk Taking, *Journal of Banking and Finance*. No. 18, pp. 307-323. New York. December.

- Kane, Edward. J. 1996. The Increasing Futility of Restricting Bank Participation in Insurance Activities. *Universal Banking: Financial System Design Reconsidered*, I. Walter and A. Saunders (eds.), Chicago, Irwin, pp. 338-417.
- Kelly, E. J. 1985. Conflicts of Interest: A Legal View. In Ingo Walter (Ed.) *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, New York, John Wiley & Sons, pp. 231-54.
- Khanna, Tarun, and Krishna Palepu, 2000, Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups, *Journal of Finance*, 55:2, 867-91.
- Khanna, Tarun, and Yishay Yafeh, 2001, Business Groups and Risk Sharing Around the World, Working Paper, The Wharton School and Harvard Business School.
- Klein, Peter and Marc R. Saldenberg. 1998. Diversification, Organization, and Efficiency: Evidence from Bank Holding Companies. Mimeo, University of Georgia and Federal Reserve Bank of New York, May.
- Kroszner, Randall S. and Raghuram Rajan G. 1994, Is the Glass-Steagall Act Justified? A Study of the US Experience with Universal Banking Before 1933, *American Economic Review* 84, 810-832.
- Kroszner, Randall S. and Philip E. Strahan. 2001, Throwing Good Money After Bad? Board Connections and Conflicts in Bank Lending, NBER Working Paper 8694.

- Kwan, Simon H. 1997. Securities Activities by Commercial Banking Firms' Section 20 Subsidiaries Risk, Return, and Diversification Benefits. Federal Reserve Bank of San Francisco, CA. October.
- Laeven, Luc, 2002, Bank Risk and Deposit Insurance, *World Bank Economic Review*, Vol. 16, No. 1, pp. 109-137.
- Lehar, Alfred and Otto Randl, 2001, Chinese Walls in German Banks, mimeo, University of Vienna.
- Lins, Karl and Henri Servaes, 2002, Is Corporate Diversification Beneficial in Emerging Markets?, *Financial Management*, Summer 2002 Volume 31, Number 2.
- McCoy, Patricia C. ed., 2002, *Financial Modernization After Gramm-Leach-Bliley*, Lexis Publishing Company, Newark, NJ.
- Puri, Manju. 1994. The Long-term Debt Default Performance of Bank Underwritten Security Issues. *Journal of Banking and Finance* 18, pp. 397-418.
- _____ 1996. Commercial Banks in Investment Banking Conflict of Interest or Certification Role? *Journal of Financial Economics*, 40, pp-373-401.
- Ramirez, Carlos 1995, Did J.P. Morgan men add liquidity? Corporate investment, cash flow, and financial structure at the turn of the century, *Journal of Finance* 50:661-78.

- _____, 2002, Did Bank Security Affiliates Add Value? Evidence from the Commercial Banking Industry During the 1902s, *Journal of Money, Credit and Banking*, 34, No. 2:393-411, May 2002
- Santos, João A.C. 1998a. Securities Activities in Banking Conglomerates: Should Their Location Be Regulated? *Cato Journal*; 18:93-117, Spring/Summer
- _____. 1998b, Commercial Banks in the Securities Business: A Review, *Journal of Financial Services Research*, 14:1, 35-60.
- _____. 1999. Bank Capital and Equity Investment Regulations. *Journal of Banking and Finance*, 23:1095-1120 July 1999.
- Saunders, A. 1985. Conflicts of Interest: An Economic View. In Ingo Walter (ed.), *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, John Wiley & Sons, New York, pp. 207-30.
- _____, 1994. Banking and Commerce: An Overview of the Public Policy Issues. *Journal of Banking and Finance* 18: 231-54.
- Saunders, A. and Ingo Walter. 1994. *Universal Banking in the United States*, Oxford, Oxford University Press.
- Scott, David. 1994. The Regulation and Supervision of Domestic Financial Conglomerates. World Bank, Policy Research Paper 1329.
- _____. 1995. Regulation and Supervision of Financial Conglomerates: The new groupwide approach and what it means for World Bank operations. World Bank. Financial Sector Development Department (FPD) Note No. 36. March.

- Stulz, René, 2001, Does Financial Structure Matter for Economic Growth: A Corporate Finance Perspective, in Demirgüç-Kunt, Asli, and Ross Levine (Eds.), 2002, *Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development*, MIT Press, Cambridge, MA., pp. 143-188
- Taylor, Michael. 1995, Bank supervision: model solutions. *Central Banking* (U.K.); 6:74-79, Autumn 1995
- _____ and Alex Fleming. 1999. Integrated Financial Supervision: Lessons of Northern European Experience. World Bank Research Paper 2223, November.
- Vander Venet, Rudi 1994. Economies of Scale and Scope in EC Credit Institutions. *Cahiers Economiques de Bruxelles*, No. 144, 507-548.
- _____. 2002. Cost and Profit Dynamics in Financial Conglomerates and Universal Banks in Europe. *Journal of Money Credit and Banking*, 34:1, 254-82.
- White, Eugene. 1986. Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks. *Explorations in Economic History* 23, pp. 33-55.
- World Bank, 2001, *Finance for Growth: Policy Choices in a Volatile World*, Washington, D.C.

Annex Table 1: Permissible Activities for Banking Organizations in Various Financial Centers

Country	Securities ¹	Insurance ²	Real Estate ³	Bank Investments in Industrial Firms ⁴	Industrial Firm Investment in Banks
<i>G-10 countries plus Switzerland</i>					
<i>Belgium</i>	Permitted	Permitted through subsidiaries	Generally limited to holding bank premises	Single qualifying holding may not exceed 15% of bank's own funds and such holdings on an aggregate basis may not exceed 45% of own funds	Permitted, but subject to prior approval of authorities
<i>Canada</i> ⁵	Permitted through subsidiaries	Permitted through subsidiaries	Permitted	Permitted up to C\$250M per entity or 10% of regulatory capital.	Permitted, depending on size of bank, to own from 20 percent of voting shares for large banks (greater than C\$5B equity) to 100 percent for small banks (less than C\$1B equity).
<i>France</i>	Permitted	Permitted; usually through subsidiaries	Permitted	Permitted, but limited to 15% of the bank's capital; in the aggregate limited to 60% of the bank's capital	Not prohibited
<i>Germany</i>	Permitted	Permitted, but only through insurance subsidiaries	Permitted	Permitted, but limited to 15% of the bank's capital; in the aggregate limited to 60% of the bank's capital	Permitted, subject to regulatory consent based on the suitability of the shareholder
<i>Italy</i>	Permitted	Limited to 10% of own funds for each insurance company and 20% aggregate investment in insurance companies	Generally limited to holding bank premises	Permitted, up to 15% of the bank's capital, subject to approval of the Bank of Italy	Permitted, up to 5% of shares of the bank, subject to the approval of the Bank of Italy

Country	Securities¹	Insurance²	Real Estate³	Bank Investments in Industrial Firms⁴	Industrial Firm Investment in Banks
<i>Japan</i>	Some services (e.g., selling of government bonds and investment trusts) permitted to banks, others permitted through subsidiaries.	Some services (e.g., selling insurance policies in connection with housing loans) permitted to banks, others permitted through subsidiaries.	Generally limited to holding bank premises	Limited to holding 5% interest ⁶	Permitted, provided total investment does not exceed investing firm's capital or net assets
<i>Netherlands</i>	Permitted	Permitted through subsidiaries	Permitted	Subject to regulatory approval for voting shares in excess of 10%	Subject to regulatory approval for voting shares in excess of 5%
<i>Sweden</i>	Permitted	Permitted	Generally limited to holding banking premises	Limited	Not prohibited, but such investments are generally not made
<i>Switzerland</i>	Permitted through specific license as securities dealer	Permitted through subsidiaries	Permitted	Permitted	Not prohibited
<i>United Kingdom</i>	Permitted; usually conducted through subsidiaries	Permitted through subsidiaries	Permitted	Permitted, subject to supervisory consultations	No statutory prohibition
<i>United States</i>	Permitted, but underwriting and dealing in corporate securities activities must be done through (1) a nonbank subsidiary of a bank holding company (subject to limits on revenue), (2) a nonbank subsidiary of a financial holding company (no revenue constraints) or (3) a financial subsidiary of a national bank (no revenues limits)	Insurance underwriting and sales are permissible for nonbank subsidiaries of financial holding companies. National banks and their subsidiaries are generally restricted to agency sales activities	Generally limited to holding bank premises	Permitted to hold up to 5% of voting shares through a bank holding company (BHC), but a BHC that is designated as a financial holding company and has a securities affiliate may exercise merchant banking powers to make controlling investments, subject to certain regulatory restrictions.	Permitted to make non-controlling investments up to 25% of the voting shares

Emerging Markets:					
Country	Securities¹	Insurance²	Real Estate³	Bank Investments in Industrial Firms⁴	Industrial Firm Investment in Banks
<i>Argentina</i>	Permitted	Permitted, but only with regard to pension fund affiliates	Limited; based on bank capital and investment	Limited	Permitted but subject to prior approval of authorities
<i>Brazil</i>	Permitted through subsidiaries	Permitted through subsidiaries	Generally limited to bank holding companies	Limited to suppliers to the bank	Permitted
<i>Chile</i>	Permitted	Insurance brokerage permitted	Not permitted	Not permitted	Permitted, but only up to 10% of a bank's shares, after which the Superintendent's prior approval is required
<i>China</i>	Not permitted	Not permitted	Not permitted	Not permitted	Not permitted
<i>Hong Kong</i>	Permitted, subject to limits based on the capital of the bank	Permitted, subject to limits based on the capital of the bank	Permitted, subject to capital and other regulatory limits	Permitted, subject to limits based on the capital of the bank	Permitted, subject to regulatory consent based on suitability of the shareholder
<i>India</i>	Underwriting permitted; trading activities through subsidiaries	Not permitted	Generally limited to bank holding companies	Limited to 30% of the capital funds of the banks	Permitted up to 30% of the capital and reserve of the investing company subject to approval of RBI of the transfer of 1% or more of the bank's capital
<i>Indonesia</i>	Permitted through subsidiaries	Permitted through subsidiaries	Not permitted	Not permitted	Permitted
<i>South Korea</i>	Permitted through affiliates	Permitted through affiliates	Generally limited to holding bank premises and to 60% of bank capital	Subject to prior approval for investments in excess of 15%	Permitted, up to 10% of the bank's capital, but subject to prior approval based on suitability of the shareholder
<i>Mexico</i>	Permitted through affiliates	Permitted through affiliates	Generally limited to holding bank premises	Not permitted	Permitted up to 20% of the shares with approval

Country	Securities ¹	Insurance ²	Real Estate ³	Bank Investments in Industrial Firms ⁴	Industrial Firm Investment in Banks
<i>Singapore</i>	Banks may hold equity participation in stockbroking firms with MAS approval	Locally incorporated banks may own insurance companies with MAS approval	Limited in the aggregate to 20% of bank's capital	Interests in the excess of 10%, or that give the bank significant influence over the management of a company, require regulatory approval. In addition, a bank may not invest more than 2% of its capital funds in any individual firm.	Acquisitions of 5%, 12% and 20% or more each require regulatory approval
<i>South Africa</i>	Generally permitted, but subject to financial reporting requirements	Banks may not hold more than 49% of a registered insurer	Bank may not hold more than 10% of their total liabilities in fixed assets, loans and advances to certain subsidiaries and investments in, loans and advances to, certain associates	Banks require prior permission from the Registrar to establish subsidiaries within South Africa or to acquire an interest in companies outside of South Africa	Permission is required from the Registrar for holdings in excess of 15% and from the Minister of Finance for holdings in excess of 49%
<i>The Philippines</i>	Permitted; universal banks may engage in securities activities directly or through a subsidiary with limitations; regular commercial banks may engage in securities activities only through subsidiaries with limitations	Insurance companies/ insurance agency and brokerage permitted for universal banks through subsidiaries with limitations; insurance agency and brokerage permitted for regular commercial banks through subsidiaries with limitations	Permitted for universal banks through subsidiaries with limitations	Permitted for universal banks through subsidiaries with limitations	Permitted with limitations on foreign and/or corporate ownership s

1. Securities activities include underwriting, dealing and brokering all kinds of securities and all aspects of the mutual fund business.

2. Insurance activities include underwriting and selling insurance as principal and as agent.

3. Real estate activities include real estate investment, development and management.

4. Including investments through holding company structures.

5. Updated on the basis of personal communication with Gerry Salembier, Financial Services Agency, Canada.

6. Bank holding companies and their subsidiaries are allowed to hold in the aggregate up to 15% of the total shares of non-financial companies.

Source: Institute of International Bankers. Regulatory and Market Developments. Global Survey 2002; New York, September 2002.

Annex 2: Data definitions in Barth, Caprio and Levine

Barth, Caprio and Levine (2001b) have developed a regulatory database, which includes *Bank Activity Regulatory Variables*. They measure the degree to which the national regulatory authorities in their sample countries allow commercial banks to engage in the following three non-traditional interest-spread-based activities:

- (a) **Securities:** the ability of commercial banks to engage in the business of securities underwriting, brokering, dealing, and all aspects of the mutual fund industry.
- (b) **Insurance:** the ability of banks to engage in insurance underwriting and selling.
- (c) **Real Estate:** the ability of banks to engage in real estate investment, development, and management.

They conducted surveys to obtain official information regarding each country's regulations concerning these activities for the year 1999. Using this information, they rated the degree of regulatory restrictiveness for each activity from 1 to 4, with larger numbers representing greater restrictiveness. The definitions of the 1 through 4 designations used were as follows:

- (1) **Unrestricted** – A full range of activities in the given category can be conducted directly in the bank.
- (2) **Permitted** – A full range of activities can be conducted, but all or some must be conducted in subsidiaries.
- (3) **Restricted** – Less than a full range of activities can be conducted in the bank or subsidiaries.
- (4) **Prohibited** – The activity cannot be conducted in either the bank or subsidiaries.

The difference between a 1 and 2 indicates only the locations in which the activity is conducted, not whether the activity is restricted in any way. This type of difference, however, may matter for financial development and performance as well as for bank stability. More generally, these types of regulations determine the degree to which a bank may diversify its business operations as well as to attempt to capitalize on any synergies that may arise from complimentary activities.

Annex Tables 2 and 3 reproduces the average for the whole sample by regional and income groups as reported in Barth, Caprio and Levine (2001b).

Annex Table 2: Information on Bank Regulatory, Supervisory and Deposit Insurance Variables						
Variable	Number of Countries Providing Information	Mean	Median	Standard Deviation	Minimum value	Maximum value
<i>Bank Activity Regulatory Variables</i>						
(a) Securities Activities	107	1.87	2.00	0.88	1.00	4.00
(b) Insurance Activities	107	2.73	2.00	1.00	1.00	4.00
(c) Real Estate Activities	107	2.90	3.00	1.07	1.00	4.00

Source: Barth, Caprio and Levine (2001b)

Annex Table 3: Averages by Income and Regional Groupings			
	(a) Securities Activities	(b) Insurance Activities	(c) Real Estate Activities
By Income			
High Income	1.43	2.32	2.38
Upper middle-Income	1.96	2.60	3.00
Lower Middle Income	2.23	2.81	3.15
Lower Income	2.11	3.58	3.42
Developed countries	1.37	2.22	2.04
Developing countries or emerging markets	2.04	2.90	3.19
Offshore Centers	1.88	2.75	3.00
By Region			
Americas	2.18	2.59	2.82
East Asia and Pacific	2.41	2.76	3.24
Europe and Central Asia	1.51	2.27	2.27
Middle East and North Africa	1.45	3.45	3.73
South Asia	1.67	3.17	3.33
Sub-Saharan Africa	2.07	3.36	3.43
By Category			
Non-OECD	2.00	2.90	3.16
OECD	1.50	2.25	2.14
Non-EU	1.99	2.82	3.07
EU	1.13	2.20	1.87
Non-Euroland	1.96	2.79	3.02
Euroland	1.09	2.18	1.82

Source: Barth, Caprio and Levine (2001b)

Annex 3: Costs and benefits of different organizational models

Three organizational models can be distinguished: (i) the fully integrated banking model; (ii) the bank-parent model; and (iii) the holding company model. A fourth model is one that forces complete institutional separation between commercial and investment banking, i.e., the separate banking system model. An additional model is the use of a narrow bank that isolates the risk of securities as well as commercial banking business from depositors. Since this model is not specific to the issue of IFSP, it is not discussed.

Integrated Banking Model. In countries where banks have full latitude, most banks locate the securities unit in a department of the bank, thereby adopting the full-integrated bank model. This way resources can be shared among the organization's various departments with maximum flexibility, allowing the bank to fully realize informational advantages and economies of scope and scale. Moreover, it increases banks' ability to diversify its sources of revenue. At the same time, safeguards for limiting conflicts of interest and extending the safety net are limited (Santos 1998a and 1999; Saunders 1994).

The Bank-Parent Company Model. In the bank-parent model, the securities business is undertaken by a subsidiary of the bank. As there is a legal separation, integration of the bank and the securities activities can only be achieved partially and the potential for economies of scope is thus reduced. However, this model still allows for risk diversification and the potential for higher revenues through cross selling of financial services. The bank-parent model can reduce the potential for conflicts and

the extension of the safety net—provided regulations requiring firewalls between bank and its subsidiaries and prescribing arms-length transactions are in place.

The Holding Company Model. In this model, a holding company owns both the bank and the securities subsidiary, with legal separation between the two. Separately capitalized and incorporated units with each unit offer different products its own management team, accounting records and capital. This generally limits the exchange of information, personnel, or other inputs among the various units, thus reducing economies of scale and scope and the bank's ability to exploit informational advantages synergies. The holding company structure can limit risk diversification potential as revenues generated by securities activities accrue to that unit and then to the holding company. At the same time, the holding company can act as a source of financial strength to the bank subsidiary. Advantages of the bank holding company structure are that the potential for conflicts is reduced and that the extension of the safety net may be limited (see further Santos 1998a).

¹ The paper does not review the issues raised by IFSP in terms of financial consolidation, supervision or in terms of the best organization structure for supervisory agencies (e.g., single or multiple supervisory authorities). See Scott 1994 and 1995, Taylor and Fleming 1999, and the papers by White, by van Lelyveld and Schilder, and by Kuritzkes, Schuermann and Weiner in this volume for reviews of these issues. Clearly, there are tradeoffs, including whether one can economize on supervisory skills and achieve supervisory independence, important issues in emerging markets. It neither reviews the benefits and costs of different internal organizational models for financial institutions (see Annex 3 for some considerations).

² This is often called “universal banking.” On the one hand universal banking is typically thought of only as including commercial and investment banking and not insurance. On the other hand there are other aspects often associated with universal banking—such as the possible ownership of non-financial institutions, which do not relate to financial services provision. The benefits and costs of ownership of non-financial institutions by financial institutions (the so-called “bank and commerce” links) and associated effects, including so-called crony capitalism, are not discussed here. I will rather continue to use the term IFSP to refer to a wide scope of financial services provision within a single institution.

³ A fourth class distinguished by IIB is real estate services. Since real estate services are not financial services only, I mention them only as a memo item.

⁴ This classification uses the legal restriction as the measure. If banks were allowed to conduct securities activities in the bank itself, but typically conduct securities activities in a subsidiary, then it was still considered to be unrestricted. It also did not

consider the need to obtain approval from the regulator to conduct securities activities as a restriction.

⁵ The classification of insurance activities is even more complex than that of securities related activities as regulations sometimes distinguish between the selling of insurance as an agent, as a broker, or as a principal. Furthermore, regulation may vary by type of insurance product. No attempt was made to weigh the importance of the restrictions. Any rules except those involving requiring general permission or imposed for prudential reasons were considered to restrict a bank's insurance activities. Alternative criteria could thus only lead to more countries with no or few limitations. As a memo item, slightly less than half of countries (21) permit banks to provide real estate services (such as real estate investment, development and management); some 27 countries limit banks to only holding their own premises or otherwise impose limits, whereas 6 countries allow real estate activities mainly through subsidiaries.

⁶ The table reports for completeness also the restrictions on real estate and ownership of non-bank financial institutions by banks.

⁷ As a memo item, most countries are still more restrictive on real estate activities, with only one-third of 107 countries (35) having no restrictions whatsoever or permitting it only within some limits.

⁸ Under the Section 20 of the U.S. Bank Holding Company Act, revenues that commercial banks derive from their securities subsidiary (underwriting and dealing activities) used to be restricted to less than 25 percent of their overall profits. Moreover, commercial banks were not allowed to hold an equity stake in non-financial firms (except for trading purposes). The 1999 GLB-Act changed this dramatically.

⁹ For other recent reviews see Santos, 1998b, and the paper by Walter in this volume.

¹⁰ There is more evidence on economies of scale. Most empirical studies have found that the bulk of scale economies are captured, but not fully exhausted, by the time a bank has \$2 to \$10 billion in assets. Early studies for US banks found that economies of scale were exhausted for relatively small sizes (see Clark 1988 for a review). Later, studies have found evidence of scale economies up to the \$ 2-10 billion in assets (Noulas, Ray and Miller 1990, and Hunter, Timme and Yang 1990). Other empirical evidence for US banks actually suggested that economies of scale may start to decline for asset sizes between \$10 to \$25 billion (Berger, Hunter, and Timme 1993). More recent evidence suggests, however, higher economies of scale for banks. This may reflect the increased importance of information technology for banks. The few tests that have been conducted for other countries largely confirm these results. In a study based on non-US data, Saunders and Walter (1994) and Vander Venet (1994) find economies of scale in individual loans of up to \$25 million. Lang and Welzel (1995) find scale economies among German universal banks up to a size of \$5 billion. Evidence for emerging countries is very limited (see Laeven 2002).

¹¹ Others, however, have found for the period before the repeal of the Glass-Steagall Act that hypothetical mergers of US banking and securities firms would not always have reduced risks. Santomero and Chung (1992), for example, find that mergers between bank holding companies and regional securities firms would reduce overall risk, but that mergers with large firms would raise the risk of failure for the new organization.

¹² The question of scope of financial services is then also related to the costs and benefits of bank-based versus capital market-based systems, which in turn may have implications on firms' access and cost of capital and economic growth. For an

overview of this literature, see Stulz, 2001. For a discussion of the links between the scope of banks' powers and the orientation of a country's financial system, see Allen and Gale, 2000. In practice, the distinction bank versus market-based financial system does not seem to offer much guidance, however, on the functioning of a financial system (Beck, Demirgüç-Kunt, Levine, and Maksimovic, 2002, and Beck and Levine, 2002).

¹³ To my knowledge, there are also no major cases where risks have been transferred from insurance or pension fund businesses to banks; as such, it seems the risk may arise mainly from securities activities.

¹⁴ Another reason to review the safeguards is the disappearing line between financial services and information services and other non-bank institutions involved in "near" financial services. In many countries, information service providers, such as credit card companies, provide near-banking services. Also, portals engaged in price comparisons provide near financial services. Combined with the entry of non-financial service providers, the lines between financial and non-financial institutions are blurring quickly. In some countries, non-banks are offering forms of payment services through multiple purpose stored-valued cards. Also, the links between banking and commerce may be intensifying through direct investments, strategic alliances, and other forms of cooperation. Non-bank financial institutions, not just banks, have then the potential to be sources of systemic risk. These developments may result in a de-facto extension of the public safety net to various forms of non-financial institutions in times of financial distress and create spillovers from non-financial corporations to the financial sector. This risk of an extension of the safety net may be especially important in emerging markets because there has been a tendency to define the safety net too widely in these countries. At the same time, a

solution of regulating and supervising non-bank institutions is surely not feasible, implying that the solution has to lie in reducing the scope and access to the safety net. See further Claessens, Klingebiel and Glaessner, 2002.

¹⁵ Indeed, the former head of the International Monetary Fund, Michel Camdessus remarked in 1997 that we are witnessing “... the development of new types of financial instruments, and the organization of banks into financial conglomerates, whose scope is often hard to grasp and whose operations may be impossible for outside observers – even bank supervisors – to monitor” (cited by Barth, Caprio and Levine, 2001a).

¹⁶ Wilmarth (2002), for example, argues that the “major financial holding companies (in the U.S.) are largely insulated from market discipline and regulatory oversight, and they have perverse effects to take excessive risks at the expenses of the federal “safety net” for financial institutions.” While this may be a very strong view, it shows that there exist concerns of too large financial conglomerates even in countries like the U.S. where there is little history of ex-post bailouts of financial firms.

¹⁷ Although many, including international financial institutions, have actively promoted the development of stock markets, success has been limited in most emerging markets (see further Claessens, Klingebiel and Schmukler, 2002).

¹⁸ For real estate activities, the averages are 3.19 for developing countries compared to 2.04 for developed countries. The difference between the sample of 54 countries of Institute of International Bankers 2001 and the larger sample (107 countries) surveyed by Barth et al. 2001b is that the latter includes more low-income countries. The fact that Barth et al. sample shows on average more restrictions is thus another indicator that developing countries tend to have more restrictions on activities.

¹⁹ No formal statistics are available on the share of financial conglomerates even for developed countries, in part as it has been hard to come up with a common definition of a financial conglomerate.

²⁰ Another set of question relates to the role of groups as conglomerates and the functioning of internal markets, which are not being addressed here.