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Would Universal Banking Benefit the U.S. Economy?

Hyman P. Minsky Ph.D.

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Hyman P. Minsky
Jerome Levy Economics Institute
of Bard College
Annandale on Hudson, NY 12504

On the narrow question of whether universal banking would benefit the United States economy my view is that a shift to universal banking will not be big thing.

By universal banking I take it we mean that a broad private profit seeking "universal banking" institution will have some liabilities which function as money that enjoy special protection from the Central bank or deposit insurance agencies of the Government. Monetary liabilities cannot be allowed to become non performing assets to their holders, because it is believed that if this happens a serious fall in the market value of assets, in current output prices and in employment will follow. These falls will be part of an interactive process that leads to a serious depression. (In other words bank liabilities are protected because a debt deflation theory of great depressions still underlies our views of the monetary dynamics of capitalist economies.)

The organization of a universal bank will need to be such that its monetary liabilities are entered upon the balance sheet of a well defined separate entity. The concern about the critical need to assure that the monetary liabilities of a universal bank are default free assets leads to the proposition that in the United States universal banks will be organized as holding companies.

If we take the performance of the United States economy over the 1948-70 (or so) as a practical best, it is evident that the United States economy did very well with a segmented or compartmentalized banking/financial system. This evidence from history indicates that universal banking is not necessary for a capitalist economy to do well. Advocates of universal banking need to show that the current American and world economies are sufficiently different from the United States economy of the 1948-1970 period so that the historical record of doing very well with a compartmentalized banking/financial system is no guide to what is needed in our time.

Furthermore if the "*division of labor is determined by the extent of the market*" then the growth of finance relative to industry and trade indicates that specialized institutions will exist and prosper even as universal banking is permitted. Using modern communicating and record keeping techniques, financial organizations that are specialized by function and location should be able to survive and prosper. Very much depends upon the legal restrictions to entry that will be part of the legislation that formally permits universal banking.

It is a misreading of history to say that the Glass Steagel act separated investment and commercial banking. Under the National Banking Act national banks were formally excluded from engaging in investment banking. The erosion of this barrier took place because state chartered institutions were not barred from the trust business and from engaging in investment banking activities. National banks avoided the restriction by having state chartered affiliates which engaged in trust and investment banking activities.

We can expect that universal banking will come in the form of holding companies, whose charters will allow for virtually any combination of financial and non-financial operations by subsidiaries. Presumably the holding company format will protect the integrity of the monetary liabilities of the commercial banks and precisely demarcate the part of the holding company that may be too big to fail. National incorporation may well come to the United States in the legislation which permits universal banking.

The great collapse of banking, the financial structure and the economy over 1929-33 is the initial condition for the current legislated structure of banking and finance. The legislation that aimed to put *Humpty Dumpty together again after the great fall* included not only the emergency legislation of 1933 but also securities and exchange legislation, housing and agriculture financing institutions, rural electrification financing authorities, a government investment bank (The Reconstruction Finance Corporation) and a revised Federal Reserve System. (The second Federal Reserve System, of 1935 to date, is significantly different from the failed first Federal Reserve System, of 1913-1933.) The segmented structure is a horses for courses approach to the provision of assets and the financing of activity whereas the universal banking approach is a one size fits all.

The concepts underlying the reconstruction of the financial system in the 1930's emphasized the role of the banking and financial structure in

1. providing a safe and secure means of payments and
2. financing the capital development of the economy.

One aspect of this reconstruction was the shift from tying the reserve base of banks and the supply of currency to the monetization of private paper (the 1913 act) to allowing the reserve base of banks and the supply of currency to be linked to the Federal Reserve's holdings of government debt. (the 1935 act). This government debt based structure gave the Federal Reserve rather than the needs of trade control over the amount of currency and bank reserves.

The premises of the securities and exchange legislation of the 1930's are

1. that for the foreseeable future the United States is going to be a capitalist economy in which the corporate form is the dominant way of organizing business and
2 active markets for the purchase, sale and underwriting of

corporate equities exist and the value of business organizations as going concerns are set in these markets.

Another premise underlying the legislation of the 1930's was that the dominant public interest in overseeing the corporate form of organizing business was to assure the rights of stockholders. Ever since the New Deal American capitalism has had a stockholder centric bias. The critical elements in this stockholder centric structure for publicly held companies are that the results of current corporate operations and the structure of corporate balance sheets shall be *transparent* and that the markets on which corporate securities are floated and traded shall be both *transparent and trustworthy.*

One distinction between commercial and investment bank financing is that commercial banks specialize in *opaque* transactions while investment banks and the markets in which financial instruments are issued and traded specialize in *transparent* transactions. Merchant banking activities, in which *banking* firms commit their capital by taking positions in firms, parts of firms and instruments which manage risk, are often hybrid transactions. While each particular deal is "*opaque*" the public has to be kept informed that these transactions are taking place.

Merchant banking activities also include making markets and taking positions in what is euphemistically called the managing of risk. Today merchant banking activities are carried out by organizations which are chartered as banks as well as by organizations which are not so chartered.

Every universal bank will need to set a precise limit to the equity it allocates to merchant banking activities. Given the size of the possible capital losses and gains in such merchant banking, some means of "insulating" commercial banking activities from merchant banking activities of conglomerate organizations chartered as universal banks will be necessary.

The development of what can best be called money manager capitalism, in which mutual and pension funds are the dominant proximate "owners" of the equity and debt liabilities of corporations is a major change in financial arrangements since the 1930's reconstruction of the financial system. These mutual and pension funds presumably act for the benefit of the households who are the ultimate owners of the assets these organizations have in portfolio: they stand in a fiduciary relation with the owners of their liabilities.

There is ample evidence that the ethics that guides many operators in the financial services industry, including some in our most prestigious outfits, is summarize by a remark cited in The Economist in April 1994: *"If God had not meant them to be sheared, He would not have made them sheep".* In the further development of the banking and financial structure the relations between banks, commercial, investment, and merchant, and the management of mutual and pension funds needs to be considered . Given the evolution of institutions over the past decades I would like to suggest that those institutions which manage money and are in a fiduciary relation with households be separated from institutions whose primary focus is upon trading and investing for the benefit of the owners of the firm's capital and their staff whose compensation is based upon performance. Universality may well exclude pension and mutual funds.

There is a possible adverse effect of universal banking in that the number of independent banking institutions will decline even as equity bases are likely to increase. The natural financing habitat of a banking institution is given by its capital accounts and a prudential limit on its exposure to any one account. This natural habitat will increase as the consolidation of banking into fewer but larger institutions takes place. This evolution would leave unsatisfied pockets of potential bank clients. Any formal move towards universal banking will need to meet such unsatisfied fringes by allowing ready into banking to be relatively unrestricted.