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FUTURE DEVELOPMENTS AND STRUCTURAL CHANGES IN RETAIL BANKING IN EUROPE: SOME IMPLICATIONS FOR BANK REGULATORS

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ABSTRACT

The future development of retail banking and the structural changes that are occurring, and are expected to occur after 1992, are two issues which dominate current discussions concerning banking in Europe. Both issues are inter-related and, of course, both have implications for bank regulation. In an attempt to contribute to the debate, this paper presents survey data obtained from retail banks in thirteen European countries and highlights differences between banks in EC countries with those in EFTA countries. We are also concerned with the regulatory implications of the data and, having discussed why banks should be regulated at all, conclude that banks should be regulated on a functional basis, and that banks should not be permitted to engage in non-banking activities, nor non-banks permitted to undertake banking business.

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1. INTRODUCTION

There are two main issues dominating discussions concerning European retail banking: the likely developments of the system over the next ten years; and the structural changes occurring now and in the future, in particular after 1992. Both of these issues are inter-related and, of course, both have implications for bank regulators. This paper, therefore, addresses the two issues and, having considered why banks should be regulated at all, makes recommendations as to the manner in which banks should be regulated in the future.

1.1 Future developments

One of the more interesting questions which is facing bank management, regulators and academics is how is retail branch banking going to develop over the next ten years. In an attempt to provide some answers to this question, this paper presents survey data that has been obtained from banks throughout Europe. The original intention was that the survey should be conducted in all OECD countries, but pilot study returns indicated that we would be unlikely to receive responses from banks in France, Ireland, Japan, the Netherlands, Norway and the United States. It was therefore decided that the study would concentrate on European banks, with the exception of those countries previously mentioned, and we surveyed 127 banks selected from the 1989 Banker 'top one thousand banks'[1].

The questionnaires were posted during February 1990, with a reminder being sent in May 1990, and the response rate from banks in 13

European countries, was some 38 per cent. The data from five countries includes their top bank; a further five countries includes their number two and/or number three bank. The remaining three countries, Greece, Sweden and West Germany, include a bank ranked fifth or less and, therefore, the results from these three countries should be treated as being of indicative purposes only. One purpose of the survey was to try and ascertain whether there was any difference in outlook between banks in EC countries and those in EFTA countries; and thus the survey results presented in this paper keep this distinction in mind.

1.2 Structural changes

There have been a number of studies examining the structural changes that are occurring, and are expected to occur after 1992, within the context of European banking. For example, Gardener (1987) discusses the structural and strategic consequences which arise from the financial conglomerate trend which has eroded the distinction between commercial and investment banking; and Neven (1989) assesses how 1992 will affect the structure of retail banks in Europe. However, what appears to have received less attention, at least in the European literature, is the growing trend for banks to engage in non-banking activities. In this paper, therefore, we are concerned with two interrelated issues concerning structural change: (i) the increasing trend of lending to the non-corporate sector; and (ii) the entry of banks into non-banking business and vice versa.

All of the issues dealt with in this paper have obvious implications for bank regulators, but in order to consider these

implications we have to ask a more fundamental question namely, why should banks be regulated at all. Whilst we believe that banks must continue to be regulated, that is only part of the answer; the observed changes in bank behaviour requires new thinking on the part of the regulators; and the conclusion we offer is that bank regulation requires a new theoretical foundation.

The plan of this paper is as follows: In Section 2, we discuss the changes that occurred to retail bank branch numbers during the 1980s, and present our projections for the 1990s; we also examine the question of if, and how, the interior of these branches will change over the next ten years. During the 1990s we expect to see an increasing reliance by the banks upon technology to service their personal customers and, therefore, in Section 3 we examine the data in connection with the provision of automated telling machines (ATMs). Of course, the expected changes, to both branch numbers and the technology used, have staff implications; and we examine the employment data in Section 4. The important question of the amount of competition facing retail banks in Europe is considered in Section 5, when we also examine how the banks expect the proposed EC Second Banking Directive to affect them.

In Section 6, we present survey evidence showing that, with the apparent notable exception of Sweden, banks throughout Europe increased their lending to the personal sector, and decreased lending to the corporate sector, during the 1980s. We also present data illustrating how the banks have moved into non-banking business; which, of course, has not been a one way process. And we examine how non-banking firms have been able to enter the banking sector in Denmark and the United

Kingdom. This diversification can, of course, be explained by means of industrial economic theory, and in Section 7 we examine the justification, and possible concerns, of such movements by considering the evidence from the United States.

All of the changes and movements mentioned above must have implications for bank regulators, and so these are considered in Section 8, by asking why should banks be regulated at all; and if they are, what exactly should be regulated. In answering these questions, we suggest that a new theory of bank regulation is required to enable the regulators to perform their function more efficiently. The paper ends with some conclusions and policy recommendations in Section 9.

2. RETAIL BANK BRANCHES

During the period 1985-89, European banks increased the number of their domestic retail branches by an average of some 6 per cent. However, within both the EC and EFTA groups it is noticeable that there is a divide between the northern and southern countries. Table 1 shows that whilst banks in the EC northern region reduced the number of their domestic branches by an average of some 6 per cent between 1985 and 1989, banks in the EC southern region, Spain and Greece in particular, increased the number of branches by an average of 15 per cent. It is likely that this difference is due to the level of development of the financial infrastructure in 1985, and therefore the southern countries high percentage increase represents attempts to increase the number of bank branches to a similar level found in the north[2].

Over the next ten years we expect that banks in the EC northern group will reduce the number of branches by some 18 per cent, whilst banks in the EC southern group will increase the number of branches by about 30 per cent. By the year 2000 we are expecting to see that, on a 1985 basis, the northern EC will have reduced bank branches by some 21 per cent, and the southern EC to have increased bank branches by some 50 per cent. We are also expecting a similar situation within EFTA, with Finland and Sweden reducing their bank branches by an average of some 25 per cent; Austria and Switzerland to have increased the number of branches by the same amount. The expected net result for the EFTA countries is, therefore, no change.

Table 1 European retail banking

Branch structure

Percentage change 1985-2000

	Domestic Branches 1985/89	1985/2000	1989/92	1989/95	1989/2000	Total branches 1985/89	1985/2000	1989/92	1989/95	1989/2000
EC-North										
Belgium	-12	-35	-18	-22	-27	-12	-35	-18	-22	-26
Denmark	- 7	-29	-11	-24	-24	- 5	-26	-10	-22	-22
Luxembourg	2	0	- 2	- 2	- 2	4	8	2	4	4
UK	- 6	..	..	..	..	..	..	..	..	..
Average[1]	- 6	-21	-10	-16	-18	- 4	-18	- 9	-13	-15
EC-South										
Greece	20	61	16	34	34	20	66	17	37	38
Italy	5	28	22	22	22	5	29	23	23	23
Portugal	16	61	22	32	39	16	59	19	29	36
Spain	19	51	21	24	26	19	51	21	24	26
Average	15	50	20	28	30	15	51	20	28	31
EC Average	6	20	7	9	10	7	22	8	10	11
EFTA										
Austria	16	31	8	11	12	17	34	9	12	15
Finland	0	-33	-11	-22	-33	0	-33	-10	-21	-32
Sweden	- 1	-18	- 8	-13	-17	- 1	-13	- 6	-10	-13
Switzerland	8	18	10	10	10	12	26	11	11	12
EFTA Average	6	0	0	- 4	- 7	7	4	1	- 2	- 5

Notes: .. Not available
1. Excluding UK

For all countries, except Denmark and Finland, we expect that the majority of the adjustments will have been completed by 1992, and almost all changes by 1995. It would appear that the rate of adjustment will be slower in the Scandinavian countries than in the rest of Europe but, of course, the figures may indicate a lack of the respondent's confidence beyond the five year time horizon.

Domestic branches are only part of the story and, so, Table 1 also shows the analysis of the total number of bank branches (domestic + international) which gives some indication as to whether the retail banks are expecting to change the number of their international branches. Again it is noticeable that the EC southern group is expecting to expand their international networks during the 1990s, whilst the EC northern group are expecting to reduce the number of their branches.

One word should be mentioned here concerning the United Kingdom, and that is that all of the British banks surveyed refused to give any indication as to their thinking concerning the next ten years on the grounds of confidentiality and sensitiveness of the data. However, we would expect that certain of the large banks, notably Barclays and NatWest, will attempt to maintain if not increase their overseas offices; the Midland's strategy will depend upon whether the proposed merger with Hong Kong & Shanghai Bank proceeds or not.

With regard to EFTA countries, it would appear that Finish banks assume that their overseas representation will not change relative to the 1980s; but this may be due to them not having fully completed their

1990s planning. Banks in Austria, Sweden and Switzerland are expected to increase their overseas offices.

Questions were also asked concerning the design of bank branches. 82 per cent of EC banks and 88 per cent of EFTA banks expect to change the interior of their branches by the year 2000. When asked how, the reply was the same irrespective of location: increased customer comfort and space; fewer security screens, because of the increasing use of ATMs to deal with cash; and more staff devoting their time to selling products.

One reason for the reduction in the number of bank branches is that the technology now available precludes the necessity of a physical branch in order to conduct banking business. From the personal customer's point of view, the most significant change in banking technology has been the widespread increase in the provision of ATMs during the 1980s and we now consider the development of this technology in the next section.

3. TECHNOLOGY

The provision of bank ATMs increased rapidly during the 1980s, in particular after 1983. Between 1985 and 1989, the average increase for EC banks was some 117 per cent; for EFTA banks some 229 per cent. Table 2 shows the analysis, and for the future we are predicting that, whilst the absolute numbers will increase, the percentage rate of increase will decline after 1995. Indeed, in most countries the

Table 2 European retail banks

Change in ATM installations 1985-2000

(per cent)

	1985/89	1985/2000	1989/92	1989/95	1989/2000
EC					
Belgium	91	456	155	173	191
Denmark	80	374	99	163	163
Greece	141	400	49	95	107
Italy	91	252	40	58	84
Luxembourg	140	300	25	67	67
Portugal	22[1]	22[2]	0	0	0
Spain	257	453	27	36	55
UK	50	..	..	..	..
EC Average	117[3]	322	58	85	95
EFTA					
Austria	155	211	6	10	22
Finland	451	525	10	12	13
Sweden	35	208	129	129	129
Switzerland	273	526	25	63	68
EFTA Average	229	368	43	54	58

Notes: .. Not available
1. 1988/89
2. 1988/2000
3. This excludes the United Kingdom. If the United Kingdom were included, the EC average would be 109 per cent

expansion will be completed by 1992, although Austria and Switzerland appear to be an exception to this generalisation. The expected decline after 1992 is due, primarily, to the fact that, in some countries at least, the saturation level of ATM installations is quickly being reached.

It should be noted at this point that the economics of providing an ATM network are extremely complex, and that there is still much debate as to whether in fact the provision of an ATM is cost effective for most, if not all, banks throughout Europe. This question is also being considered by banks in the United States, and there is a growing view that ATMs are not, in fact, cost effective. Thus, in cities such as Chicago, the banks are replacing their ATMs with extended opening hours; with some banks now providing a daily service to their customers. Obviously, whether an European bank adopts such a policy will depend, at least in part, upon legislation; and in countries such as the UK, where Sunday trading is permitted in Scotland but not in England and Wales, the position seems to be extremely muddled. However, we are expecting that there will be a net increase in the number of ATMs within all European countries between now and the year 2000.

However, there is some debate as to what exactly counts as an increase in the provision of an ATM. The reasons for the dilemma are as follows. When ATMs where first introduced they simply dispensed a set amount of currency. Then, in the 1980s, ATMs became more sophisticated and they were able to perform several functions, such as issuing statements and ordering cheque books, in addition to dispensing cash, However the technology seems to be changing again, and it now appears that it is more efficient to install dedicated machines, as has happened in Switzerland in particular. Thus, Swiss banks tend to have one ATM to dispense currency; another that will print a statement/answer inquiries; and a third which dispenses foreign currency. Similar trends have been noticed within the UK, although at present they tend to be restricted to lobby, as opposed to through-the-wall, machines.

One important factor concerning ATM economics is the length of time people are prepared to queue to use the machine. It is possible that as the ATMs have become more sophisticated, queuing time has increased, and usage has, therefore, been discouraged. As the economics of ATMs depends almost entirely upon usage rates this, of course, is not to the advantage of the ATM owning institution.

It is our view that the development of specialist ATMs will continue, at least for the next five years, but that this development will also be subject to the development of ATM networks within a given country. Currently, the number of national ATM networks varies from one country to another: within the UK there are currently three major networks; in Denmark there is one network for all commercial banks; and Sweden has one network for the commercial banks, and another for the savings banks.

Standard economic theory suggests that utility would be increased if all networks were in fact amalgamated, at least within each individual country. If we assume that one result of 1992 will be an increase in banking competition within EC countries, then the provision of international networks should be encouraged. However, we would not go as far, at this moment in time, as to suggest that an EC, or even a world, network is possible, although such a network should, in theory, be the optimal solution.

The problem with shared networks is that the ATM owner does not know whether they are able to increase their market share because of ATMs. There is a concern, expressed by several banks, that customers

use their particular bank because of the provision of ATMs. Therefore, if the name on the ATM was changed to that of a particular network, or if the number of ATMs was rationalised because of a national, or international, network the individual institution could lose business. Further is the problem of location. It is possible that the institution holding (providing space for) the ATM would gain business at the expense of the institution that had lost the installation. Of course, one answer to this problem would be for the ATMs to be provided in specialist premises/locations such as retail stores, railway stations or airports.

The increase in the use of ATMs, together with the reduction in the number of bank branches, has obvious staff implications which are considered in the next section.

4. EMPLOYMENT

Throughout the 1980s European banks increased their staff numbers considerably. Indeed, it is interesting to note that as branch numbers declined, staff numbers increased. The argument that increased levels of technology would reduce employment does not appear to have been born out by events, but this point ignores the increase in total business conducted by the banks. Individual countries have experienced different rates of increase in labour due, again, to the different level of development of their particular financial infrastructure/size of average bank branch.

4.1 Branch staff

We expect that the EC northern region will reduce staff numbers during the 1990s as shown in Table 3. The reduction will be driven not only by the increase in the provision of technology, but also, and perhaps more importantly, by the need to reduce costs because of increased competition. However, we expect that the EC southern group will continue to increase their staff numbers; but both groups present a somewhat confused picture. Belgium, for example, expects to increase total staff, but to reduce domestic branch staff. For the EC group as a

Table 3 European retail banking

Predicted employment changes in selected countries 1990-2000

(per cent)

	Total staff		Domestic branch staff	
	1990/95	1990/2000	1990/95	1990/2000
EC				
Belgium	22	35	-12	-20
Denmark	-14	-14	-31	-31
Greece	10	12	9	11
Luxembourg	13	13	10	15
Portugal	-11	-21	- 7	-17
Spain	2	2	3	4
EC Average	4	5	- 5	- 6
EFTA				
Austria	5	10	5	12
Finland	-11	-19	-13	-21
Sweden	- 8	-17	-29	-29
Switzerland	0	0	- 5	-10
EFTA Average	- 4	- 7	-11	-12

whole we are expecting an average increase of some 5 per cent in total staff by the year 2000, and a reduction of some 6 per cent in domestic branch staff. Again, the major changes will occur prior to 1995.

With regard to EFTA countries, only Austria appears to be expecting an increase in staff, all other banks reported expected decreases, amongst their domestic branch staff in particular. The expectation is that EFTA banks will reduce their total staff by some 7 per cent, and domestic branch staff by some 12 per cent. The similar employment pattern between the three Scandinavian countries should also be noted.

The proportion of total staff employed on domestic branch business will also change, and we expect that European banks will have converged to a ratio of about 55/45, branch to total staff, by the year 2000. Table 4 shows that this adjustment is going to be more pronounced within EC countries, but it would appear that banks in Finland, Greece and Portugal expect to increase their branch staff ratios.

4.2 Graduate recruitment

What is more important than the changing ratios is that the quality of the staff employed is expected to increase noticeably over the next ten years. The banks were questioned about their policy on recruitment of graduates, and we are expecting the number of graduates employed by European banks to increase by between ten and 100 per cent over the next ten years; and by the year 2000, graduates could represent about 19 per cent of total staff. Table 5 presents the analysis and shows that banks in both Denmark and Finland expect to employ significantly

Table 4 European retail banking

Domestic branch staff as a percentage of total staff 1985-2000

(selected countries)

	1985	1989	1990	1992	1995	2000
EC						
Belgium	..	..	31	28	22	18
Denmark	60	55	50	46	40	40
Greece	81	86	84	84	83	83
Luxembourg	24	23	23	23	23	23
Portugal	74	75	79	84	83	82
Spain	95	95	80	81	81	82
EC Average	67	67	58	58	55	55
EFTA						
Austria	50	50	50	50	50	51
Finland	83	83	90	90	89	88
Sweden	57	69	58	52	45	50
Switzerland	38	31	37	37	35	33
EFTA Average	57	58	59	57	55	56

Note: .. Not available

Table 5 European retail banking

Predicted graduate employment changes in selected countries 1990-2000

(per cent)

			% of total staff	
	1990/95	1990/2000	1990	2000
EC				
Belgium	40	100	14	20
Denmark	38	62	3	6
Greece	16	31	20	23
Portugal	49	82	10	23
Spain	61	117	9	18
EC Average	41	78	11	18
EFTA				
Austria	18	31	8	10
Finland	5	10	7	9
Sweden	33	50	25	45
Switzerland	43	107	7	15
EFTA Average	25	50	12	20

less graduates than the European average; but the very high figure for Sweden is possibly due to a 'small number' problem[3].

The increased demand for graduates will have implications for the educational system throughout Europe, and already banks in the UK, for example, are attempting to recruit graduates from the continent because of supply difficulties. It should also be noted that one of the proposed EC rules on recognition of professional status is that a 'qualified banker' shall be a person who has (1) obtained a university degree, and (2) undergone a recognised training programme with a commercial bank of not less than two years. This proposal has been

resisted, somewhat, by the British because of the status of the Chartered Institute of Bankers and the Institute of Bankers in Scotland, both of whom could, of course, lose students if their qualification was not recognised.

5. COMPETITION

All of the respondents thought that the level of competition in banking will have increased by the year 2000. But, of course, what is more interesting is where the perceived threat is considered to be coming from. Only one European bank (British) expects that their most important competitor will be a foreign bank in the year 2000; all other respondents expect that their main rival will be the same as now: another domestic bank. This may be an honest view, but we have to doubt the thinking.

Respondents were asked to apply a ranking (1 to 6) to indicate what type of firm was their most important competitor from the given list of: other domestic banks; foreign banks; building societies (savings and loans); retail stores; insurance companies; other institutions. The analysis, presented in Table 6, shows a clear difference in view between EC and EFTA banks.

Whilst all respondents, with the notable exception of Greece, ranked domestic banks as their most important customer, the importance of foreign banks is much more clearly felt in the EC, ranked 2, than in EFTA, ranked 5. The clear number 2 threat in EFTA is the insurance

Table 6 European retail banks

Perceived competition 1990

(average rating[1])

	Other banks	Foreign banks	Building societies	Retail stores	Insurance companies	Other institutions
EC						
Belgium	1	2	3	5	4	6
Denmark	1	5	3	4	2	6
Greece	2	1	3			
Italy	1	2	3	5	4	6
Luxembourg	1=	1=			3	
Portugal	1	2=	4	5	2=	6
Spain	1	3	2	4=	4=	
UK	1	3=	2	5	3=	6
W. Germany	1	3	4	5	2	6
EC Average	1	2	3=	5	3=	6
EFTA						
Austria	1	4	3	5	2	6
Finland	1	5	4	3	2	
Sweden	1	5	2=	4	2=	6
Switzerland	1	4=	3	4=	2	
EFTA Average	1	5	3	4	2	6

Note: 1. '1' = most important competitor

industry, as it is in West Germany and Denmark. The consensus view of banks in EFTA appears to be that foreign banks are not a threat, least of all in Scandinavia.

Again the existing infrastructure, and legislation, within a particular country will, to a large extent determine who the real competitors are. But we feel that the EFTA thinking may well be right; it depends upon how much importance should be attached to a branch network, as opposed to a national network of staff.

When asked if the proposed 1992 changes had affected their strategic planning, 64 per cent of EC (but only 40 per cent of the British) and 75 per cent of EFTA respondents agreed. The banks' reaction to 1992 appears to be that they have been forced to become more aware of foreign markets; and it is interesting to note that the non-European respondents had changed their strategy by opening London offices, and/or ensuring that their capital adequacy rules matched those of the EC.

6. BANK ASSETS AND BUSINESS CHANGES

In this section of the paper we firstly examine how the retail banks in most European countries are relying increasingly on lending to the personal sector in order to increase their total assets; and, secondly, we examine the entry of banks into non-bank business, and the entry of non-banks into the banking sector.

The data presented in this section of the paper were obtained from a survey which we have recently conducted with retail banks throughout Europe. In our view, due to the number of banks responding, the data in respect of Greece, Sweden and West Germany should be considered as being of indicative purposes only.

6.1 Bank assets

By history and tradition, a retail bank lends personal sector surpluses to the corporate sector. Indeed, 'good banking' was considered, at

least in the United Kingdom, to be lending from 'seed time to harvest'. However, during the 1980s there was a trend towards reversing the traditional role, and banks in most European countries found that they were lending corporate sector surpluses to the personal sector.

During the period 1985-89, our survey revealed that bank lending to the corporate sector declined by an average of some 11 per cent in EC countries, and by 4 per cent in EFTA countries. It was also found that, during the same period, bank lending to the personal sector increased by an average of 13 per cent in the EC countries, and by some 8 per cent in EFTA countries (if we ignore Sweden).

The analysis of the survey data is presented in Table 7 which also shows that there was a reverse trend in respect of deposits. For the period 1985-89, personal sector bank deposits decreased by an average of 4 per cent in EC countries, and by an average of 2 per cent in Austria and Finland. EC corporate sector bank deposits increased by some 21 per cent, and in Austria and Finland by some 8 per cent.

Whilst these changes did occur, it should be noted that only the Belgian banks found that in 1989 they lent more to the personal sector (55 per cent) than to the corporate sector (45 per cent). Table 7 also clearly indicates the fact that banks in Sweden do not appear to have followed the trend in other European countries, but rather have increased their personal sector deposits, and decreased their personal sector assets. However, this may reflect the particular respondents experiences, as opposed to the whole Swedish banking system.

Table 7 European retail banks

Proportions of Deposits and Assets 1985-89

	Deposits						Assets					
	Personal			Corporate			Personal			Corporate		
	1985	1989	% change	1985	1989	% change	1985	1989	% change	1985	1989	% change
EC												
Belgium	84	76	-10	16	24	50	46	55	20	54	45	-17
Greece	86	85	- 1	14	15	7	33	35	6	67	65	- 3
Italy	79	76	- 4	21	24	14	5	16	220	95	84	-12
Portugal	84	82	- 2	16	18	13	20	25	25	80	75	- 6
Spain	..	..		..	..		68	77	13	32	23	-28
UK[1]	..	..		..	..		38	39	3	62	61	- 2
Average	83	80	- 4	17	20	21	35	41	13[2]	65	59	-11
EFTA[3]												
Austria	65	63	- 3	35	37	6	16	18	13	84	82	- 2
Finland	91	90	- 1	9	10	11	66	68	3	34	32	- 6
Sweden	66	75	14	34	25	-26	75	60	-20	25	40	60
Average	74	76	3	26	24	- 3	52	49	- 1	48	51	17

Notes:
.. Not quoted
1. 3 Banks only. Source: Johnson 1990b, Table 1
2. Excluding Italy
3. The Swiss banks declined to answer these questions

The more interesting question is why these changes have occurred; and we suspect that corporate customers are increasingly finding that they are able to raise funds out-with the traditional retail banking sector. Further, lending to the personal sector normally means lending at a higher margin and, therefore, is more profitable business from the bank's point of view.

Given the need for increased profits within the retail banking sector throughout Europe, it is more than likely that the data presented here represents a strategic decision on the part of the banks concerned. Of course, lending to the personal sector is usually more risky than lending to the corporate sector and, therefore, the implication of this change in bank behaviour is that the risk of bad debt will increase. And there is already evidence from the United Kingdom that British banks are having to increase their personal sector bad debt provisions significantly.

6.2 Non-banking business and non-banks

All of the respondents to our survey expect the level of domestic competition to increase significantly over the next ten years; and that their major competitor is, and will remain, other domestic banks. For banks in the EEC, 1992 should increase the level of competition and, consequently, the pressure on profitability. It would appear that one way that European banks in general are responding to the competitive threat is to diversify into non-traditional banking business, insurance and real estate in particular.

Banks in all of the countries surveyed, with the exception of Switzerland, have entered the insurance sector; and all banks, with the exception of Belgium and Switzerland, have started real estate operations. It is perhaps interesting to note at this point that not one of the respondents intimated that they now offered stock broking or market making business. It would seem therefore that, as far as our respondents were concerned, what the literature considers to be non-banking business is different from a banks perception of what business it is actually in. Other non-traditional business mentioned were travel agencies (Belgium, Spain and the United Kingdom); car hire (Portugal and the United Kingdom); and advisory/computer services (Italy, Spain, the United Kingdom, West Germany, Sweden and Switzerland).

As can be seen from Table 8 the length of time that banks have been directly involved with insurance business varies from country to country, banks in Spain having had the longest association dating from at least 1904. Of course, a distinction must be drawn between banks acting as agents on behalf of an insurance company, and banks actually conducting underwriting business. The trend would appear to be that most European banks have begun to act as underwriters.

In the United Kingdom, for example, banks did not become involved directly with insurance business until the 1970s. Before then, a branch manager, acting in a personal capacity, was normally an insurance agent; indeed it was considered a 'perk' of the job. From 1971 onwards the clearing banks established insurance broking subsidiary companies, and the managers were bought out. Since then, due to regulatory changes in the insurance market, banks must declare to their customers whether the

insurance advice they are giving is for one company only, or if the bank is acting as an independent advisor.

Table 8 European retail banking

Non-traditional business entry dates

(selected banks)

	Insurance	Travel agency	Real estate	Car hire	Computer services
EC					
Belgium	1984	1980			
Denmark	*		1989		
Italy	1983		1980s		1989
Portugal	1987		1988	1989	
Spain	1904[1]	1984	1989		*
UK	1971[2]	1970s	1983	1987	1968
W. Germany	*		*		*
EFTA					
Austria	1986		1982		
Finland	*		*		
Sweden	1970		1970		*
Switzerland					*

Notes:
- * No date specified
- 1. 'Insurance operations are contemplated in (the bank's) foundation by-laws'
- 2. British banks have had a much longer informal association with insurance business; see text

As far as underwriting activities are concerned, it would appear that the British banks entered this particular activity by realising that they could underwrite the risks in property insurance in connection with properties they were holding as security for mortgage loans. In other countries, such as France and West Germany, some banks have formed

alliances with insurance companies and others, Deutsche bank for example, have set up their own life insurance companies; and Lloyds bank, in the United Kingdom, has purchased a significant shareholding in an insurance company.

If the association between banks and insurance business has a relatively lengthy history, the same point cannot be made about the fact that so many European banks now own estate agencies. This has been very much a product of the late 1980s, although banks in Sweden indicate an involvement since the 1970s. It should also be noted that banks are not alone in having moved into the estate agency business; building societies and insurance companies have also established estate agency chains.

The provision of computer services has involved data processing, usually pay roll services, and/or specialist databases: for example, EC legislation and grants (Spain and the United Kingdom); patent information (Switzerland); and one Swiss bank has used its computer services to sell tickets for 'pop' concerts over its branch counters.

Of course, the entry of banks into non-traditional business is not a one way process. Non-banks such as insurance companies, retailers and industrial companies, have all entered the financial services sector. Further, building societies are acting more and more like banks and, in the United Kingdom, one building society has converted its status to that of a bank, and other societies are actively considering the same change.

To show how non-bank firms can enter the financial services sector, we now give a few examples from the United Kingdom and Denmark. In the United Kingdom, BAT Industries plc, originally a tobacco company, purchased an insurance company (Eagle Star). Insurance companies have entered the banking market by providing mortgages, in particular through their ownership of estate agency chains. They also provide credit facilities to their policy holders, by enabling annual premiums, in respect of car and property insurance, to be paid monthly; and they also provide loans to the personal sector. Retailers, such as Marks and Spencers and the Burton Group, entered the financial services sector by firstly, offering their own credit card; and, secondly by using their card database to sell further products such as personal loans and unit trusts.

In Denmark the largest insurance company, Baltica, established a holding company in June 1985. This enabled them to create a finance company which moved into stock broking and property investment, and to establish their own bank in 1987. Whilst Baltica Bank specialises in corporate finance, it does provide car loans for the personal sector, and such loans include the provision of car insurance from the parent company. Since then, Baltica has established an estate agency chain, and has also purchased a company which provides ambulance and recovery services and, to a lesser degree, fire fighting services.

But Baltica's activities have not been restricted to Denmark. In the United Kingdom, for example, they own an insurance company (Preffered Assurance) which originally offered only car insurance. They then extended their products, offering policies in respect of property

and life, etc. Now (September 1990) they have joined with an American bank licensed in the United Kingdom (Beneficial Bank) to offer their policy holders a bank account tied to a VISA card.

Experience has shown, therefore, that entry into the financial services sector in general, and banking in its widest sense in particular, is relatively easy. These developments have been made possible by two main factors: firstly, market deregulation; and, secondly, the technology now available. However, we need to ask whether society in general, and bank regulators in particular, should be pleased or concerned at the developments described in this section of the paper; and we address these issues in the next section of the paper.

7. STRUCTURAL CHANGE IN THEORY

In this section of the paper we address 3 issues: (i) why should non-financial firms wish to enter the financial sector; (ii) why should banks wish to enter non-traditional sectors; (iii) should these inter-industry movements be encouraged.

7.1 Non-banks

The, at least intuitive, primary motive for a non-financial firm to enter the financial sector is one of profit. For example, to a retailer operating on a gross profit margin of some 8-10 per cent, the prospect of lending margins in excess of 15 per cent is extremely attractive. The provision of credit facilities should also increase turnover within

the store. Therefore, the retailer, by offering credit facilities, obtains additional profit from the increased sales and a profit from the credit granted. Given that there are now well established credit-scoring techniques, bad debts can be minimised, and the risk should be covered by the profit margin on lending.

A less obvious, but more important, reason for entering the financial services sector is that it enables the firm to obtain control over its own financing arrangements. This will not only reduce costs, but could also imply that lending propositions are scrutinised less severely. And by reducing costs, profits are increased yet again.

In the United Kingdom, non-financial firms entering the credit card market have done so by firstly using an established credit card company to provide the necessary expertise, usually for the first two years of operation. The Bank of Scotland has provided most of this expertise within the United Kingdom. Of course, once a database of credit worthy customers is established, this can be used to market not only the company's own products and services, but also the provision of further financial services such as personal loans and unit trusts.

Of course, the phenomena of non-financial firms becoming banks is not a new one. For example, the British Linen Bank in Scotland, Lloyds Bank in England, and Chase Manhattan in the United States all started life as non-bank firms; being a trading company, ironmasters, and a waterworks company respectively. What is different today is that market deregulation has permitted non-financial firms to exploit the opportunities available within the financial sector.

7.2 Banks and non-traditional business

If it is a profit motive that has driven non-financial firms to enter the financial sector, then the obvious question is why should financial firms wish to enter the non-financial sector. The answer to this question, we suggest, is vertical integration, which also carries the added advantages of increased profits and increased size. The last point being of particular interest to European banks on the basis that larger firms are less likely to be subjected to a hostile take-over. Of course, the fact that banks control non-banking businesses is not restricted to Europe, and in the United States, for example, the Federal Reserve System has permitted bank holding companies to control thousands of non-bank firms such as discount brokerage, credit life insurance underwriting, data processing, futures commission merchanting and export trading.

The advantages obtained from vertical integration can be considered by reference to Table 8. If, for example, your bank offers mortgages as one of its products, then by owning an estate agents you can offer your product at the very moment that a customer needs a mortgage, namely when they purchase a property. In the United Kingdom, most mortgages are now offered tied to a life assurance policy and, therefore, by operating an estate agency three items of profit are collected: the fee for selling the property; the profit on the mortgage; and the profit on the assurance premiums. In the same way, a travel agency provides the opportunity for marketing, and receiving profit from, foreign exchange transactions and travellers cheques. Travel and health insurance can also be sold and the bank again collects several items of profit. The

provision of computer services is, by comparison, an attempt to reduce operating costs, in just the same way as joining an ATM network is. In both cases over capacity can be 'sold' to enable average operating costs to be reduced and, thus, increase total profitability.

7.3 Should banks be permitted to operate non-bank business?

If we can explain, albeit in a somewhat simplified manner, inter-industry movements, the obvious question that remains is: should we be concerned at such movements. And this is a question which has been subjected to much debate in the United States over the past three years. We feel that there are two issues here: industrial firms acquiring financial companies; and banks moving into non-bank business. With regard to new entrants to the banking sector, we deal with this issue in the next section of the paper, but for now merely assert our belief that society should be concerned, and further, that such entry should be prohibited.

The advantages for banks entering into non-bank activities are usually summarised as being a decrease in the risk of bank failure, and a reduction in the variability of bank profits. The belief that diversification reduces the risk of bank failure is founded on the assumption that the subsidiary company provides additional profits to the bank, whilst the legal structure protects the bank from losses made in the subsidiary company. However, evidence from the United States would appear to indicate that these beliefs are misfounded. In two studies, (Boyd and Graham (1986) and Boyd and Graham (1988)), it has been found that increasing non-bank activities actually increases the

risk of bank failure. And if we assume, as the bank holding company legislation does, that bank failure results in social costs, then the advisability of permitting banks to engage in non-bank business has to be questioned.

In the second study mentioned, the authors addressed the question of whether mergers between bank holding companies and non-bank firms would reduce the risk of failure, because increased average rates of return would offset increased variability of rates of return. They used data for 249 publicly traded banks, securities houses, insurance companies and real estate agencies for the period 1971-84 and simulated mergers between these firms.

Boyd and Graham (1988) found that only mergers between banks and life assurance companies would reduce both the volatility of return and the risk of bank failures. Mergers between banks and securities houses or real estate agencies increased the risk of bank failure and the volatility of returns. In neither study do the authors attempt to explain why their results indicate that increased non-bank activity increases the risk of bank failure and we therefore have to ask whether their results are valid.

We would suggest that their results are valid and can be explained in terms of business cycles. If we think of the example of a bank operating an estate agency chain, then both firms are going to follow a similar business cycle; that is, a downturn in general economic conditions will coincide with a downturn in the demand for property. Therefore, if the estate agency is being operated with its own branches

and staff, then income will be reduced at the same time as the demand for bank loans is also reduced, and bad debts are increasing. In the United Kingdom, for example, all of the estate agency chains made losses in calendar years 1988 and 1989. These losses amounted to well over £100 million each year, and the indications are that they will also report losses in respect of the current year - 1990.

We also feel that the problem of banks owning securities houses is similar to that just described. In contrast, life assurance companies do not suffer in the same way from business cycles; the average life policy in the United Kingdom being written for between 10 and 25 years. Because of this longer time, horizon life assurance companies, the visitation of plagues excepted, experience a far more stable profit record.

Of course, the risks associated with operating non-bank business can be reduced significantly by not establishing separate companies. If the bank wishes to increase its profitability by providing more outlets for its product, mortgages through estate agents for example, then a risk-free approach would be to appoint other firms as agents to act on behalf of the bank. This business practice, although not common now, has sound historical foundations: it was by the use of agents that the Scottish banks expanded their business operations during the eighteenth and nineteenth centuries. As an alternative, the bank could act in a pure agency capacity for other firms. This would entail making no new capital commitment to the new venture, but rather utilising existing staff and premises, and receiving a commission from the other firm for

any business undertaken. And this, of course, was the position with UK banks and stock brokers prior to 'Big Bang'.

Having considered the advantages and disadvantages of inter-industry movement in as far as it affects financial firms in general, and banks in particular, we now need to address the question from a regulatory point of view, and this we do in the next section of this paper.

8. REGULATORY IMPLICATIONS

Having established the fact that banks are moving into non-banking business, and can be expected to do so in the future, in this section of the paper we address the questions of should bank regulators be concerned, and if so, how should bank regulations be altered. In an attempt to answer these questions we will firstly ask the more basic question of why should a bank be regulated at all. It is, we feel, essential that the problem is addressed in this way, for if we do not understand why a bank is regulated, then we are unable to decide whether new business practices are acceptable. We find that the reasons normally put forward to justify bank regulation are unsatisfactory and, even to some extent, contradictory. We suggest, secondly, therefore, a new theory as to why banks should be regulated. In the third part of this section of the paper we consider on what basis regulation and supervision should be conducted by the authorities. It is our view that regulations, and supervision, should be applied on a functional basis rather than by categorisation.

8.1 Why are banks regulated?

As was shown in the previous section, non-financial firms are entering the financial sector. And the evidence from the United States and the United Kingdom suggests that these new entrants will be highly successful. In the United States, the banks' share of the financial services market has been reduced from 36 per cent in 1974 to 27 per cent at the end of 1988, and the total share of the financial services market accounted for by banks and thrifts combined has suffered a secular decline, from a peak of 55 per cent in 1974 to 44 per cent in 1988[4]. In the United Kingdom, the building societies now only account for some 50 per cent of the mortgage market as opposed to some 80 per cent of the market 10 years ago[5].

The fact that non-banks have been so successful in capturing market share raises the obvious question of whether the fact that some firms providing financial services are regulated, whilst others are not, leads to unfair competition between the regulated and unregulated firms. This question can, of course, be extended to compare regulatory influences on different financial firms. For example, in the United Kingdom, building societies have at this moment in time higher capital adequacy rules in respect of unsecured loans to the personal sector than do banks; and the building societies have to charge a higher interest rate for such loans.

Of course, one of the expected affects of 1992 within EC countries is that the authorities will engage in competitive deregulation to ensure the competitiveness of their domestic financial institutions. It

is therefore essential that we understand what a 'safe' level of regulation is, and how it should be applied. With any regulation, there is a danger that the regulations will be exploited by the regulatees in order that their monopoly should be protected; a good example being the 1844 Bank Charter Act, which established a monopoly for the Bank of England. Further, regulations tend to be set to protect the weakest firms, in a poor management sense at the expense of more efficient firms. The net result, therefore, can be that society incurs unnecessary costs, in just the same way that a good borrower has to subsidise the lender's worst payers and bad debts.

The philosophy underlying almost all bank regulation throughout the world is that the banking industry is so unstable, and the consequences of bank failure so catastrophic, that society must be protected in as strong a manner as possible; and the banks, therefore, regulated as strictly as possible. Four main reasons for bank regulation are normally advanced: protection of depositors; protection against bank runs; restriction of competition; and prevention of system failure and its economic consequences. Each of these reasons is now examined.

8.1.1 Protection of Depositors

If a bank fails, then there is a danger that depositors will lose their funds. This has been considered to be a social ill and, therefore, customers of the bank have been protected. However, why bank customers are considered to be somehow different from other types of business customer is unclear. By making a deposit, a bank customer is, in effect, making an investment for which he receives a return, either in

the form of interest or in the form of 'free' services. Indeed, it is extremely difficult to distinguish between placing a deposit with a bank, and paying a deposit for any type of service or good which will be delivered in the future. The risk of non-performance is, in some sense, almost identical, and yet society regulates the one but not the other.

If depositors were not legally protected, the efficient firms should gain at the expense of the inefficient firms; and banks would be forced to adopt safer practices, through competitive soundness. Insurance companies in the United States for example, do not like to be known as being 'innovative', as the use of that word implies risk.

Currently, it is the inefficient bank that benefits from this type of argument in favour of bank regulation and if the regulations were removed it is highly unlikely that customers would continue to use a bank which declared losses, as opposed to profits, such as the Midland Bank in the United Kingdom. It appears, therefore, that this argument in favour of regulation can only be justified on the grounds that it encourages use to be made of the banking system; not to protect depositors.

8.1.2 Protection against bank runs

The argument for this type of regulation is that if customers fear for the safety of their deposits, they would demand that their deposits were returned in currency, which could cause the bank to suffer a run, and thus become insolvent. Therefore, if a depositor was guaranteed the return of his funds by the government, bank runs would be less likely to

occur. Therefore, bank deposits are insured in countries such as the United States and the United Kingdom.

In the United States, the insurance cover now stands at 100 per cent of deposits up to a maximum of $100,000; whilst in the United Kingdom it is 75 per cent of deposits up to £20,000. However it should be noted that whilst the last bank panic in the United Kingdom occurred in 1866, the deposit insurance fund was not established until the 1981 Banking Act. There has not been a bank panic in the United States since 1933 and some writers, Gilbert and Wood (1986) for example, claim that the insurance has been an important feature for preventing banking panics. However, two main arguments can be advanced against deposit insurance: it leads to increased risk taking by banks; and it is contradictory in nature.

The argument that insuring deposits leads to increased risk taking has been put forward in the United States in particular. The argument is, briefly, that because bank management know that their depositors will not suffer from any loss incurred by the bank, they can take greater risks with the quality of their assets in an attempt to achieve high returns. Brewer (1990) found that during the period July 1984-December 1987 the stock markets reacted favourably to increased risk taking by savings and loans (S&Ls). He also found that S&Ls at risk of failure actually *increased* their high risk activities, and he suggests, therefore, that losses occurring at the S&Ls in the late 1980s were as a result of deliberate management policy to pursue high risk strategies.

However, Duan *et al* (1990) in a study of 35 US banks found that only seven of them had shifted risk to the deposit insurance corporation, and that the regulatory policies had been successful. They therefore conclude that deregulation has not resulted in an increase in risk shifting.

In the United Kingdom, it was always believed that the bank of England would act as a lender-of-last-resort, and ensure the security and stability of the financial system. And this certainly happened during the 'secondary banking' crisis in 1973 and, more recently, with the Johnson Matthy affair. It is perhaps noteworthy that despite having the insurance fund since 1981, and in contrast to the United States, no British bank actively markets the concept that a customer should use that particular bank because their deposits are insured . Therefore, we would argue, insurance is not required providing the central bank is prepared to act as a lender of last resort.

The second argument against deposit insurance is that, in reality, deposit insurance is a contradiction when the limits set are examined. If it is assumed that the poor are financially naive, then the limits established in both the United Kingdom and the United States are too high; and the position is made worse in the United Kingdom, where the poor are considered to be able to lose 25 per cent of what could be their life savings. If, on the other hand, the argument is really one of protection against bank runs, then the limit is too low. For, after all, the most important depositors, in the sense of largest deposits made, are neither poor nor financially naive. Industry, with millions of pounds at risk, would either have to increase significantly

the number of accounts and, thereby, only risk 25 per cent of the balances; or risk losing their total deposits. It seems to us, therefore, that the arguments in favour of this type of bank regulation cannot be justified.

8.1.3 Restricting competition

The theory underlying this type of regulation is that there is some 'safe' level of competition beyond which the safety of the financial system is threatened. As competition increases, so banks are forced to invest in riskier assets, by lowering their lending standards, and increase the rates paid to attract deposits which, in turn, increases the cost of loans. This theory was certainly accepted in the United Kingdom prior to 1971, and the existence of the clearing bank cartel was officially sanctioned on those grounds. Recent experience in the United Kingdom would appear to indicate that this is a real risk, and it has been estimated that between 11 and 17 per cent of all personal sector borrowers in the United Kingdom cannot easily repay their borrowings; with the extreme result of their homes being repossessed by the lenders.

However, it has to be appreciated that this situation has occurred within the existing regulations, and market forces can be expected to remedy the position. And this has happened in the United Kingdom, with the banks and building societies becoming far more stringent in their attitude towards loan applications.

Experience in the international markets has shown that free competition will reduce costs rather than increase them; competition

forces banks to seek to reduce costs in order that margins can be reduced to the benefit of the consumer. Further, given the global market of today, there is nothing to be feared from bank concentration. We consider, therefore, that regulations in order to restrict competition are unnecessary.

8.1.4 System failure

The fourth argument is that without regulation there is systemic risk, and the economic costs of permitting just one large bank to fail are too high to be contemplated. This argument relies on the multiplier effect operating in reverse. Thus the reduction in bank deposits means a greater reduction in bank assets; which leads to a reduction in the money supply. This in turn leads to reduced economic activity and, thus, increased unemployment and business failure, both of which in turn reduce deposits, and the spiral continues downward.

The theory that bank failure can cause a reduction in economic activity has been tested by Gilbert and Kochin (1989) who found that bank failure had an adverse effect on local sales in rural areas in the States of Kansas and Nebraska. They also found that bank failure had an adverse effect on employment in the States of Oklahoma and Kansas, but no significant effects in Nebraska. However, Rolnick and Weber (1985) in examining the United States free banking era (1837-1863) found that, in the four states they examined, there were no contagion effects, either across states or intra-state, resulting from any of the bank failures during that period. Similar results are found during the free banking period in Scotland in the eighteenth and nineteenth centuries.

Given that the most widely used means of payment is not currency, even if a bank failed, deposits could be transferred to other banks and assets purchased. Indeed, it is likely that should a major bank fail, foreign banks operating in the domestic country would gain by being able to purchase assets at reduced prices, whilst still being funded by deposits from their home country. We also have to appreciate that even if every single bank was to fail, means of payment would still be required, and there would be firms only too willing to provide these services, as well as provide loans. Therefore, regulation cannot be justified on the basis of this argument.

We have demonstrated that the reasons normally put forward for justifying the regulation of banks cannot stand the test of scrutiny. However, the fact that banks are regulated in so many countries of the world indicates that there must be sound reasons, other than those mentioned previously, for banks to be regulated. We therefore believe that a new theoretical framework, or set of arguments, is required to explain and justify bank regulation; and this we do in the next section of the paper.

8.2 Bank regulation: a new approach

As economists we are concerned with the allocation of scarce resources, and money, in this sense, is a scarce resource. We therefore take the view that banks should be regulated not for any of the reasons stated previously, but because they act on behalf of society in determining how the scarce resource of money should be allocated. It follows from this, that in our view, bank regulations should be aimed solely at determining

which firm may act as a bank; all other aspects being left to market forces and the threat of competition.

Our arguments are founded on reasoning propounded by Schumpeter many years ago, and which are truths that society ignores at its peril. It will also be seen that, on this basis, banks should not be permitted to enter into non-bank business; and non-banks must not be allowed to enter into banking business. We have argued elsewhere (Johnson 1990a) that only fit persons should be permitted to engage in banking business, and these arguments can be seen as being an extension of that view point.

To Schumpeter, independent bankers are an essential part of the capitalist system; and we begin by quoting from Schumpeter (1939).

> It should be observed how important it is for the functioning of the [capitalist] system.... that the banker should know, and be able to judge, what his credit is used for and that he should be an independent agent. To realise this is to understand what banking means.
>
> (p.116)

> In the case of bankers ... failure to be up to what is a very high mark interferes with the working of the system as a whole. Moreover, bankers may, at sometimes and in some countries fail to be up to the mark culpritively: that is to say, tradition and standards may be absent to such a degree that practically anyone, however lacking in aptitude and training, can drift into the

banking business, find customers, and deal with them according to his own ideas. In such countries or times, wild cat banking ... develops. This in itself - whatever the legal rules about collateral and so on may be - is sufficient to turn the history of capitalist evolution into a history of catastrophes.

(p.117)

... banks and their officers must not have any stake in the gains of enterprise beyond what is implied by the loan contract. This independence ... has always been threatened by attempts of entrepreneurs to gain control over banks and by attempts of banks or their officers to gain control over industry ... Subservience to government or to public opinion ... paralyses a banking system. This fact is so serious because the banker's function is essentially a critical, checking, admonitory one. Alike in this respect to economists, bankers are worth their salt only if they make themselves thoroughly unpopular with governments, politicians, and the public.

(p118)

Following Schumpeter's view, therefore, the answer to the questions posed in this section of the paper are quite clear. Banks should be regulated because, and only because, of their crucial role in allocating credit and thereby determining what enterprises will be undertaken and what will not. It also follows that non-bank firms should not be permitted to engage in banking activities; and that banks should not engage in non-bank activities.

8.3 The basis of regulation

If banks are to be regulated, the final question must be: how? The current position, in most countries, is that financial institutions are regulated on a categorisation basis; that is, the regulation, and supervision, of a financial firm is based upon some legal definition of the type of business conducted. And it is extremely difficult to define what a bank is. Therefore, we suggest, the basis of regulation and supervision should be one of function rather than category.

That legal definition difficulties can lead to regulatory avoidance has been seen in the United States. Under Bank Holding Company legislation, a bank was defined as being a firm which offered *BOTH* demand deposits and commercial loans. The result was the emergence of 'non-bank banks', which offered only one of these services. Whilst this loophole was closed by the Competitive Equality Banking Act of 1987, which re-defined a bank to include any firm whose deposits are insured by the FDIC, non-bank banks established before March 1987 were exempted from this law.

In the United Kingdom it is becoming increasingly difficult to distinguish between a bank and a building society: in provision of services to the personal sector in particular. Whilst the banking legislation states that a bank is a firm recognised by the Bank of England as a bank, in reality it would appear that the distinction is based solely upon ownership status: a bank has shareholders; a building society does not. The result is that the Bank of England only

supervises part of the 'banking' system; in just the same way that the Fed only supervises part of the American 'banking' system.

In the EC, after 1992, the basis of supervision will be one of 'home rule'. That is, a 'bank' will be supervised by its home regulator, irrespective of in which country it conducts its business. The problems for regulators can, therefore, be expected to increase, especially if an era of 'competitive deregulation' is entered, as seems likely.

One way to ease the regulators burden, we suggest, is to regulate on the basis of function rather than category. On this basis, the regulator would only have to ask three simple questions: does the firm accept deposits?; does the firm make loans?; does the firm make loans; does the firm provide a means of payment service? If the answer to *any* of these questions was yes, then the firm should be regulated as being a bank.

Whilst accepting deposits and making loans are, probably, clear enough functions; the provision of means of payment services would require further definition. We would include the provision of a credit card and/or an ATM card, as well as the normal cheque facilities, as being the provision of a means of payment services. thus, under this definition, firms such as retailers and insurance companies would, at least for part of their business, be considered as being banks, and supervised accordingly.

9. CONCLUSIONS

In this paper we have shown that retail banks in most European countries, as well as in the United States, are changing their behaviour in two important aspects: they have increased their lending to the personal sector; and they have engaged in an increasing fashion in non-banking business. We have also argued that, due to lax regulation, the authorities have permitted non-banks to enter the banking sector. We are concerned at these developments, and have argued that they entail an extremely high risk to the functioning of the economic system.

Having considered the theory of bank regulation, we found that the theories normally advanced in support of bank regulation are inadequate to explain why banks should be regulated. We therefore, following Schumpeter, have argued that a modified theory of regulation should be understood: that banks are regulated because of their extremely important function in the allocation of the scarce resource known as money.

Therefore, the policy implications of our analysis are clear: banks should be prohibited from engaging in non-bank business; and non-banks should be prohibited from entering the banking sector. By stating that banks should not undertake non-banking business we mean that they should not undertake, nor be involved in, any business that is not traditionally associated with banking. Of course, banks could be permitted to act in a purely agency role, but they should not have a capital stake in the firms for whom they act as agents.

Recent experience in both the United Kingdom and the United States has clearly demonstrated that banks operating non-bank firms can, and will, lose money. The banker, like the cobbler, should stick to his last.

NOTES

1. July 1989 issue.
2. It is even more noticeable for the period 1980-89: The southern countries increased branch numbers by some 50 per cent; the northern countries decreased their branch numbers by 9 per cent.
3. Also see point made in introduction concerning the Swedish data.
4. Source: Corrigan (1987)
5. Source: Financial Statistics, various issues.

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