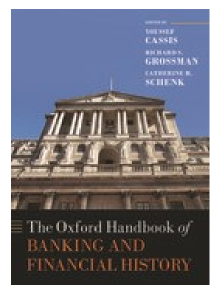

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CHAPTER

6 Commercial Banking: Changing Interactions between Banks, Markets, Industry, and State

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Abstract

This chapter provides an overview of the development of commercial banking—defined as taking deposits payable on demand and originating loans to private and corporate customers—from the mid-nineteenth century to the present. Two characteristics are underlined: state regulation, primarily dictated by concerns about banks' position as deposit takers; and banks' role in the financing of industry and more generally in economic growth including their assigned responsibility. The changing nature of these two features has shaped the development of commercial banks since the onset of industrialization. In all countries, with the exception of England, commercial banks developed into some kind of universal bank in the course of the nineteenth century. This converging movement ended in the interwar years, when in many countries commercial banks were separated from investment banks. Universal banking became dominant again in the late twentieth century, but in the form of banking conglomerates.

Keywords: commercial banks, investment banks, universal banks, regulation, industry

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Introduction

COMMERCIAL banks—institutions that accept deposits payable on demand and originate loans with personal and corporate customers—emerged in the nineteenth century in many countries. Their development is considered to be related to industrialization and economic growth. In the early years of industrialization, financial intermediation assisted economic development by mobilizing savings, mitigating risk and uncertainty, stimulating entrepreneurship, accumulating capital, and fostering development of a national legal and financial infrastructure. Consequently, the emergence of commercial banks, having deposits and loans under one roof, is often seen as the start of modern banking. Investment banks that specialize in underwriting activities, securities trading, fund management, and merger and acquisition advice are seen as another type of financial institution. Universal banks combine both commercial and investment banking activities (see e.g. Canals, 1997).

Following the distinction between specialized and universal banks, financial systems are often divided into market-based versus bank-based systems. In market-based systems, at arm's length specialized investment banks prevail, whereas in bank-based systems universal banks are dominant. The rationale behind this division is that financial markets have difficulties developing without the support of investment banks. On the other hand, it is unlikely for markets and specialized banks to develop in a financial system where universal banks dominate. The argument goes that universal banks enjoy information economies of scope acquired by the credit and deposit activities which is of value for their investment activities (and back and forth), leading to a crowding out of other types of banks. Often Germany and Japan are seen as bank-based systems where p. 111 ↳ universal banks prevail in the allocation of resources to the corporate sector, whereas in the US and England, both considered market-based systems, specialized investment banks and the financial market are dominant players. The extant literature, based on historical evidence in particular, has shown that these two dichotomies are rather stylized facts and mostly based on recent circumstances. Apart from the literature centred around the question how countries can be best classified, other literature has debated the effectiveness of both systems (Allen and Gale, 2001). However, results indicate that 'there is no support for either the bank-based or the market-based view' in this respect (Levine, 2002: 398).

The goal of this chapter is to give an overview of the development of commercial banking in different parts of the world, in particular in Europe, the US, and Japan, and to show when and how financial systems changed over time. To fully understand the systems we go back to the nineteenth century, when in many countries industrialization unfolded. During this period most commercial banks developed into some kind of universal bank, with the exception of the English specialized banks. The period between the two world wars of the twentieth century, however, was a period of divergence. In many countries, such as Belgium, Italy, Japan, and the US, banks specialized away from universal banks. Divergence lasted until the late 1970s when universal banking became the dominant form again. However, it was another type of universal bank than the one that dominated in the nineteenth and early twentieth centuries. Not only did they combine commercial and investment banking activities, but they also started operating in real estate, mortgage markets, insurance, and asset management. As banks moved into different activities servicing different types of client, they started to become multi-business companies. This new type was a kind of financial conglomerate with large international presence and a broad range of activities. The revival of universal banking in many parts of the world was a reason to question whether the commercial bank 'has outlived its usefulness and is in a state of terminal decline' (Rajan, 1998: 524). However, due to the financial crisis of 2008 this question has been reversed as policy makers are now debating whether it would be better for financial stability to separate commercial and investment banking again.

In this respect two characteristics of commercial banking should be underlined. First, commercial banks are usually regulated. The first historical reason to regulate commercial banks' activities was the capacity of commercial banks to create money as a result of being in a position to keep only a portion of their total

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deposits liquid. To assure the banks' solvency two types of regulatory measure emerged: the reserve requirement and the solvency ratio (Canals, 1993). Another measure was the securing of deposits arranged via the government often with the funds coming from the banks themselves. The system of deposit insurance is a kind of protective net to prevent serious damage when a financial institution goes bankrupt. A second reason which historically has justified regulation has been the need to ensure that credit is offered honestly and efficiently. A third reason has been the supposed need to prevent banking institutions from becoming too large, thus accumulating extreme power (Canals, 1993).

p. 112 A second important feature of commercial banks is their apparent relation with industrialization, or more broadly, with economic growth. The bank–industry relationship is the classical question in financial historiography. Two strands of literature should be mentioned here. First, in some countries, including the Netherlands, there have been debates on whether commercial banks could have contributed more to industrial development and economic growth. In this perspective it is argued that bank-based financial systems are better at allocating capital during early stages of economic development and in weak institutional environments (Levine, 1997). To stress this claim, it is put into a comparative frame, contrasting it with Germany where banks had close relations with industry enabling them to provide firms with financing (see Gerschenkron, 1962; Cameron 1967, 1972 for bringing the discussion on the role of banking in industrialization to the fore, and see e.g. Pollard and Ziegler, 1992 for comments on this relationship). An ongoing question remains, however, whether the development of commercial banks is a product or a cause of economic growth. In other words, the causal relation is still being questioned (see e.g. Levine, 1997). A second strand of literature, at least dating back to Brandeis (1914) and Hilferding (1910/1968) discusses the assumed power of banks. This literature, which has a more negative connotation, deals with interconnections between banks and industry created by financial links via the granting of loans or having shareholdings and/or by personal links via sitting on each other's boards (see for a development of these corporate networks in 14 different countries in the twentieth and twenty-first centuries David and Westerhuis, 2014).

The remainder of the chapter is set up in chronological order. It starts with the emergence of commercial banks in the nineteenth century. First, the next main section compares developments in the US and England with Germany and Japan, being typical examples of market-based and bank-based systems respectively. The following section discusses the development of commercial banks in other continental European countries in the nineteenth century. Next we describe the divergence of the financial systems in the interwar period, and then the chronology ends with the revival of universal banks since the 1980s, before offering some final remarks. Two recurring topics in this overview are banking regulation and bank–industry relations, as both are specific features of commercial banking.

Market-based vs Bank-based Systems in the Nineteenth century: England and the US vs Germany and Japan

During the nineteenth century the demand for capital increased due to industrialization and the emergence of large firms. In particular during the Second Industrial Revolution (1860–1914) large-scale companies, such as railways and oil companies, required increasing amounts of capital. The many new products and p. 113 new technologies ↳ posed information problems for external providers of finance. Joint-stock banks were created to fulfil the demand having the necessary resources in the form of deposits. We will elaborate on these general developments by comparing Germany and Japan, being defined as typical bank-based systems, with England and the US, seen as market-based systems.

In the nineteenth century the English financial sector consisted of two separate financial parts: London banking with a global outlook reflecting the country's dominant position in the international economy, and

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country banking as a product of economic transformation in the regions (Cottrell, 1992: 39). In England, joint-stock banks were prohibited until 1826, after which it became possible to establish them but only outside a radius of 65 miles from London. In 1833 this latter condition was abolished and joint-stock banks could be set up in the City as well. They were required to give up note issuing though. One of the first was the London and Westminster Bank, established in 1834. Judged on criteria such as size, links to London, and organizational structure, commercial banking matured relatively late (Cottrell, 1992: 44). Thus, the joint-stock banks that emerged as of the 1830s remained small and possessed relatively few of their own branches. Moreover, commercial banks in the country had expensive correspondent relationships with London financial markets. Typically, banks in England were able to attract high amounts of deposits, due to a historically wealthy social class, which they transformed into short-term loans and discounting (Cassis, 2006: 44). Credits to corporate clients remained relatively low, as most firms had enough capital to re-invest. Consequently, the intermediating role of banks was hardly necessary and the relation between banks and industry remained weak.

The joint-stock banks started to displace the private banks in a concentration process by which a centralized banking system developed in England. The process lasted until the 1920s and was to a substantial degree characterized by provincial banks becoming 'City institutions' (the exception being Westminster which had its origins as the first London joint-stock bank). The resulting Big Five—Barclays, Lloyds, Midland, National Provincial, and Westminster—started to dominate the English banking sector and opened further branches in the 1920s. For example, Midland Bank and Lloyds Bank, two prominent banks from Birmingham, grew rapidly in the 1880s and 1890s by acquisitions and internal expansion. They acquired banks in London linking the city with the provinces, and became large national banks. By acquisitions in the provinces they expanded the number of branches, which were an important source for deposits (Cottrell, 1992: 48).

Although in the US a growing number of joint-stock banks emerged already in 1790s, and thus earlier than in Europe, they disappeared in the 1830s. During the period 1837–1862, also known as the 'free-banking' era, the US banking system consisted of state-chartered banks. They were not allowed to establish branches. Consequently, the US banking system was highly fragmented and, in contrast to England, there was no development of nationwide banks with wide-ranging branch networks. Lamoreaux (1995) shows that the fragmented banking system became more problematic as time went by. She argues that a change from p. 114 insider to outsider orientation banking in New England ↳ was reflected by the increasing mismatch between the needs of large industrial firms and the resources of small, one unit banks. Thus, lending practices became more impersonal and professional, and the information problems banks faced when they began to conduct more of their business at arm's length forced them to concentrate on providing short-term loans to firms. Another deficit of the fragmented banking system was that the US had not developed a central bank. In particular because of the Civil War, starting in 1861, this became a more serious problem. The National Bank Acts of 1863 and 1864 were meant to set up a national banking system and to increase the federal control over the banking system. It created nationally chartered banks, which had to comply with higher capital requirements and higher reserve requirements than their state bank counterparts. To improve safety they were not allowed to make real estate loans nor to lend an amount beyond 10% of the bank's capital. Many state-chartered banks converted to nationally chartered banks because newly imposed taxes made state banking unprofitable. However, because of lower capital and reserve requirements, as well as the ease with which states issued banking charters, state banks again became the dominant banking structure by the late 1880s. The National Bank Acts created a dual banking structure, consisting of a federal and a state level, which was typical for the US banking sector.

In the US, investment banking business was centralized in a few investment banks, of which J.P. Morgan & Co. is the most well known. They played considerable roles on corporate boards of directors. As such, the Money Trust, as this network of firms and banks dominated by Morgan also came to be known, played an

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important monitoring role before the First World War (Bradford De Long, 1991). During and after the First World War when many firms approached the capital markets, an increasing number of commercial banks, such as National City Bank, became active in underwriting operations. Because the National Bank Act of 1864 did not permit national banks to handle common stocks, they incorporated affiliates under state corporate charters. These state-chartered affiliates were allowed to perform many more activities (Kroszner and Rajan, 1994). As a result increasingly more banks were extensively involved in both lending and securities underwriting activities. As we will see later in this chapter, their activities were thus similar to those of the large banks in Germany and Japan (Vitols, 2001). They engineered major corporate reorganizations such as mergers in sectors including railroads and steel through extensive shareholdings and board representation (Chernow, 1990).

In contrast to England, German banks developed close relations with industry, dating back to railroad building in the 1830s and 1840s. Universal banking was first developed by private bankers to organize and finance the construction of railroads. The bankers underwrote the issues of railroad securities, managed the firm's current accounts, and occupied key board positions (Tilly, 1989: 191; Tilly, 1992: 94). When railroad financing exceeded the resources of individual private bankers they often operated in syndicates. However, difficulties in forming and holding these syndicates together pressed them to look for alternatives (Tilly, 1989). One of those was the creation of joint-stock banks, in which private bankers continued to play a significant role. In the 1850s, within a couple of years new banks were created with the explicit purpose of financing the p. 115 ↳ nascent industry. One of the first was Bank für Handel und Industrie, also known as Darmstädter Bank, modelled after the Crédit Mobilier, and founded by the Pereire brothers together with three German private bankers. Its statutes stated that the bank was allowed to accept deposits and make loans on current account; it could hold shares in other companies, issuing securities, and organize mergers and acquisitions. In other words the bank was able to combine commercial and investment banking. Other banks followed suit: Deutsche Bank was founded in 1870 and Dresdner Bank in 1872 (see for a history of Deutsche Bank: Gall et al., 1995; Kobrak, 2008). Concentration since the 1880s led to the emergence of five large Berlin banks (Tilly, 1989). In this concentration process private banks were often taken over by the joint-stock banks, and interlocking shareholdings among joint-stock banks became important. The close links between banks and firms led to what is known as the *Hausbank* system, where firms have long-term relations with one particular bank. An important lending instrument in sustaining relationships was the current account (*Kontokorrent*) which was already used by private bankers. The current account was an 'overdraft vehicle where the borrower paid interest only on the balance outstanding at a particular time' (Guinanne, 2002: 97). Thus, credit was extended on the current account with short repayment schedules. Every time the bank renewed credits it demanded the latest information of the firm. It lent to firms or individuals for many years, because this relationship could pass from father to son. The bank built up useful information on its clients. The links between industry and banks were intensified by proxy voting in the shareholder's meeting, which enabled bankers to vote on behalf of their clients and thus to control strategic corporate decisions (see Tilly, 1992: 94). The German banks remained active in the money as well as the capital markets. Compared with other countries, the dominance of large joint-stock credit banks in the German financial system is remarkable. However, despite their importance, the largest component of the German banking landscape was still formed by private banks, savings banks (*Sparkassen*), credit cooperatives, and mortgage banks (Guinnane, 2002). It is important to note that the German case shows that financial markets and universal banks can co-exist, which is in contrast to the literature (Fohlin, 2007a, 2007b). Fohlin argues that 'the importance of universality—the combination of investment and commercial banking—appears mostly in the active use of securities markets, not in the domination of industry nor in the dramatic alteration of firm behavior or performance' (Fohlin, 2007a: 13).

The pre-war *zaibatsu*, or financial cliques, in Japan played a similar influence over industry as the *Hausbanken* in Germany and the investment banks, such as J.P. Morgan in the US. Much of the financing of Japanese firms came from commercial banks; Mitsui Bank, established in 1876, being the first one. In 1907

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the five largest banks held 21% of all bank deposits; four of them were part of a leading *zaibatsu*: Mitsui, Mitsubishi, Sumitomo, and Yasuda. Important for the emergence of *zaibatsu* has been the role of the government. When it started to privatize its firms during the Meiji period (1868–1912), most of the assets were bought by family-owned firms. Accordingly, they became major *zaibatsu* by acquiring many industrial firms during the late nineteenth century, and by 1900 these *zaibatsu*, which financed their own subsidiaries by retained earnings, had p. 116 ↳ become the most important source of finance. As the *zaibatsu* banks were allowed to borrow from the Bank of Japan at special rates, they were able to grant loans to industrial firms 'at levels well above those permitted by their own liabilities' (Lazonick and O'Sullivan, 1997: 120). By the interwar period the *zaibatsu* were the driving force behind industrial development in Japan. Also new ones emerged, such as Nissan and Nichitsu and Mori, which financed their expansion mainly via public stock issues (Lazonick and O'Sullivan, 1997).

From this short overview two conclusions can be made. First, only in England did specialized banks develop, whereas in the other three countries universal banks emerged. Even in the US, often classified as a market-based financial system, universal banks emerged. Close relations between banks and industry were established, because these universal banks granted loans and participated in security related activities, and their bankers sat on the corporate boards of directors. Second, in contrast to the other three countries, nationwide banks with extensive branch networks did not develop in the US.

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Industrialization and Joint-stock Banks in other Continental Countries

Modern banking, as defined in the introduction appeared in France around 1850. The *haute banque*, banking houses that belonged to very rich banking families, such as the Rothschilds, had remained in control for a long time. Only from 1850s onwards with the emergence of deposit banks, did this financial system start to change. The private banks were often involved in the creation of the newly joint-stock banks, sometimes as shareholders or as a member of the managing board. Crédit Mobilier, an investment bank, was established in 1852 by the brothers Emile and Isaac Pereire. Its goal was to allocate resources to firms in industry, transport, and public utility. To achieve this goal the bank had to issue bank bonds and obtain direct participation in manufacturing and railway companies. However, the government as well as the *haute banque* resisted its development. In 1854 it was not allowed anymore to issue bonds; at the same time the bank had difficulties placing the securities of the companies it had created, and often it had to take them back. The bank went bankrupt in 1867 and was liquidated four years later. More successful were, for example, the Comptoir d'Escompte de Paris, the first discount bank created in 1848, Société Générale in 1864, and Crédit Lyonnais created in 1863. These large banks increased banks' deposits in the 1890s by extending their branch network. They were followed by regional banks. However, by 1913, their total number of branches remained far behind that of English banks (Lescure, 1995: 315). At the same time, between 1880 and 1914, the large banks gave up their role as universal banks and became specialized deposit banks, as an answer to the financial crisis of 1882. Short-term self-liquidating credit became their most important activity (Lescure, 1995: 317). p. 117 ↳ The growing importance of commercial banks went in parallel with a growth of the corporate sector and a decline in private banks. In the French and other literature the role of banks in the financing of investments has been questioned. Gueslin (1992) argues that due to the consolidation of the credit institutions, banking credit remained limited and the financing of firms was done by self-financing (reinvesting cash flows) and by transfer of savings via the financial market. He also stresses financial orthodoxy in this period as an important reason, reflected for example by owners of firms distrusting credit (Gueslin, 1992: 80). Apart from the deposit banks, investment banks were created to provide long-term loans and to take participations and shareholdings in firms, such as the Banque de Paris et des Pays-Bas (Paribas). Some younger deposit banks did become universal banks, probably because of Swiss and German involvement in their establishments. Also most regional banks were shaped on the universal banking model, and here rolling-over of short-term credit often turned industrial loans into long-term credit. Gueslin (1992: 86) concluded: 'Where the local economy was buoyant, the regional banks answered to its needs, and indeed were a key element in regional growth.'

Despite Crédit Mobilier's ultimate failure it is believed that the ideas of the Pereire brothers spread over Europe, influencing the development of banking in Germany, Switzerland, and the Netherlands among others. However, according to Kurgan-van Hentenryk (1992) the Belgian banking system had already developed well before the Crédit Mobilier, that is, at the beginning of the nineteenth century with the rise of Belgian industrialization, into one that channelled funds to important parts of industry. During the second half of the nineteenth century the system was dominated by two competing banks: Société Générale (established in 1822) and Banque de Belgique (established in 1835). During the financial crises of 1876 and 1885 several financial institutions disappeared including the Banque de Belgique, leaving Société Générale, which had developed into a universal bank, with a dominant position within the Belgian banking system, as the only banking institution to supply a huge amount of capital to joint-stock companies. Société Générale developed into a major multinational bank during the late nineteenth century (Cassis, 1990; Kurgan-van Hentenryk, 1992). During the same period other important banks changed from specialized investment banks or holding companies to universal banks by combining their existing activities with those of deposit banks. As a result around the 1910s Société Générale was no longer the sole frontrunner in industrial finance, but shared this position with several other universal banks.

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The development of Dutch banking is placed between the German and English system. Here too, the concentration of wealthy classes and relatively small scale firms reduced the need for commercial banks in the modern sense of the word. Initiatives in the 1850s to set up Crédit Mobilier-style banks failed due to government resistance. In the 1860s joint stock banks were created but they focused much more on trade financing and short-term loans than on financing industrialization (in particular railways), which had been the initial idea. The absence of a modern banking sector was in the past considered the main reason for the relatively late industrialization of the Netherlands. However this view has been undermined by arguments that there were many alternatives, such as self-financing as well as financing via informal (family) networks. p. 118 ↳ The *prolongatiemarkt* also played an important role. Here one could get short-term credit for a period of three months with securities as collateral. Often credit was prolonged automatically. Due to this system well-off citizens and entrepreneurs could invest their working capital. This system, in which intermediation by banks was unnecessary, functioned well until the 1910s (Jonker, 1997). The picture changed between 1910 and 1920, when banks and manufacturing industry became more closely connected. This development was first explained by an increase in the credits granted by banks to finance the process of industrialization (Jonker, 1991). To develop a stronger capital base, a concentration process in the Dutch banking sector headed in. It resulted in the dominance of the market by five large commercial banks: Amsterdamsche Bank, Rotterdamsche Bank, Twentsche Bank, Nederlandsche Handel-Maatschappij, and Incasso Bank. In a later article Jonker concluded that concentration had not led to a qualitative change. Rather it meant an expansion of the existing type of banking, consisting of passive intermediation typical of trade financing (Jonker, 1995: 188). Recent research, focused on the demand side by investigating Dutch exchange-listed firms, shows that these firms hardly used long-term loans to finance their activities, at least until the Second World War. After an initial public offering (IPO) these firms favoured financing by retained earnings, preferred shares, and/or bonds. For investors, fixed-income bonds and preferred shares, were popular financing instruments. This preference had to do with the low degree of transparency of corporate accounts, which were not always very clear or informative, with the result that outside investors could not verify the level of profits to be paid out. Also firms themselves preferred those two financing instruments because they kept voting rights and power with the original owners (Westerhuis and De Jong, 2015). As in England and the US, a strong capital market emerged in the Netherlands, and in particular in the 1910s the stock exchange blossomed with many initial public offerings as well as issues of shares and bonds. Dutch banks often played an important role in issuing and underwriting the securities needed for the financing of industry. They sometimes granted loans in anticipation of the issue and/or kept securities in their portfolio after a failed issue but they hardly ever participated in the firms' stock. Interestingly, the Dutch case also shows that universal banks could exist alongside an active capital market (Westerhuis and De Jong, 2015). However, Dutch banks were neither as specialized as the English deposit banks, because they were allowed to be active in securities, nor entirely similar to the German universal banks, because they did not grant long-term loans or take participations in firms.

In Sweden, joint-stock banks emerged in the 1820s and 1830s, following the example of the English deposit banks. Commercial banking was dominated by short-term lending. With industrialization proceeding accompanied by an increasing demand for long-term loans, these loans were more often prolonged. Also commercial banks gradually transformed by adopting universal banking activities, such as the trade in shares and bonds. In contrast to the German universal banks, however, Swedish banks were not allowed to trade in shares on their own account until 1912. This restriction was relaxed by the Banking Law of 1911; it granted commercial banks a certain degree of freedom to purchase shares, depending on the size of a bank's equity. However, their greater p. 119 ↳ freedom went hand in hand with an extension of public control. In practice this meant that commercial banks had to be chartered by the government (Larsson, 1995; see also Larsson and Lindgren, 1992). As in the Netherlands, the 1910s witnessed a transformation of the banking sector in Sweden. Economic upheaval during the First World War up to 1920 resulted in credit expansion and an increase in the volume of share issues on the stock market. Whereas new commercial banks were established, even more banks merged to form larger organizations. Overall the number of banks was

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reduced, while the number of branches was extended considerably. The government did not intervene in the concentration process because it considered large banks more stable than smaller banks (Larsson and Lindgren, 1992: 347–8). Denmark, Norway, and Finland followed in the footsteps of Sweden (see Andersen, 2011 for the development of organized capital and credit markets in the Nordic countries).

In Switzerland banks were created on the model of Crédit Mobilier. Around the mid-nineteenth century the Swiss banking system was unable to meet the increased capital demand for financing railway construction and manufacturing industry. As a result joint-stock banks, capable of providing capital for large investment projects, emerged (Cassis and Tanner, 1992: 295). Today's big universal banks, Crédit Suisse of Zurich (CS), Swiss Bank Corporation of Basel (SBC), and the Union Bank of Switzerland (UBS)—the latter two merged in 1998—developed in this period. They emerged in a rather unconcentrated banking system consisting of cantonal banks, local banks, savings banks, and finance companies (Cassis, 1990: 163). The big banks not only became important for domestic capital accumulation but from the end of the nineteenth century onwards increasingly participated in international financial activities. However, the international financial position of the Swiss banks should not be exaggerated. Until the 1950s the Swiss banks hardly possessed overseas banks, in contrast to, for example, some Dutch and Belgian, as well as English, French, and German banks (Cassis, 1990).

To conclude, banks in many continental European countries were less specialized than the English ones, but also less 'universal' than the German ones. This overview shows that the first joint-stock banks appeared in Europe in the beginning of the nineteenth century, and although at that time they met with quite some resistance, in many countries their number increased considerably. Joint-stock banks differed from the already existing private bankers and credit houses in the higher amount of external resources and in operating under limited liability, whereas in qualitative terms fewer differences could be detected. Indeed, on the European Continent the joint-stock banks were often established by private bankers; so they performed the same activities as before but on a larger scale (Lescure, 2008: 330). In most countries, the increase in the number of banks was followed by a concentration process leading to the domination of national banking systems by a small number of large banks with extensive branch networks. As we have seen, an exception to this rule was the US where in most states branching was forbidden. But also in Portugal, Denmark, and Norway, branch banking failed to develop. Many commercial banks were used for short-term lending, attracting mainly short-term deposits. Around the 1870s and 1880s, in some countries earlier than others, these banks diversified into securities related activities due to the increasing importance p. 120 of stock markets ↳ and joint-stock firms. They provided loans in anticipation of a share issue or held securities in their portfolio. With respect to possible governmental interference banks enjoyed a high degree of freedom in their financial activities. Thus around 1900 in many countries some type of universal bank dominated in a laissez-faire regulatory regime (Vitols, 2001: 4). However, these universal banks were less universal than those in Belgium and Germany, which also participated in company stocks and focused more on long-term credits. The only real exception was England where a clear distinction between specialized banks (deposit banks, merchant banks, stockbrokers) was apparent.

In this period the stylized distinction between market-based versus bank-based systems does not seem so clear-cut. On the contrary, in most countries a hybrid form emerged. Evidence from Germany (Fohlin, 2007b; Fear and Kobrak, 2010), the US (Kroszner and Rajan, 1994) and the Netherlands (Westerhuis and De Jong, 2015), shows that universal banks and active capital markets could co-exist. This finding is in contrast to what is stated in the existing literature that argues that markets cannot prevail in a financial system where universal banks dominate. Thus, in this hybrid form banks played an important role as 'special intermediaries' in both the corporate governance of firms and stock exchanges (Fear and Kobrak, 2010: 733). We will now analyse how in the interwar period divergence between the financial systems took off, and what factors played a role in the divergence.

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Divergence of Banking Systems in the Interwar Period

The differences between financial systems were not yet very clear in the nineteenth century. In fact it might be better to trace the roots of the distinction between market-based versus bank-based financial systems back to the first decades of the twentieth century. In this respect the divergence seems to be related to two different banking crises—in some countries in the 1920s and in others in the 1930s (Jonker and van Zanden, 1995)—and subsequent banking legislation.

The country best known for its separation between commercial and investment banking has been the US. Due to the Great Depression the US federal government took several measures to prevent banking institutions from becoming too big and too powerful. A series of severe banking crises and bank closures between 1930 and 1933 led to the Glass–Steagall Act of 1933 which separated commercial banking from investment banking and prevented state banks from acting as advisors in mergers and acquisitions and issuing of corporate debt (Canals, 1997: 10). Combined with an increasing support for restrictions on interstate banking, the Act ensured that banks were restricted even more than markets (Allen and Gale, 2001: 34). Thus the distrust of power in the hands of some large financial institutions resulted in antitrust legislation preserving competition in the banking sector. Consequently many relatively small banks persisted in the US.

 In Belgium and Italy, two countries where universal banks had been dominant, the depression of the 1930s also led to a separation between investment and commercial banking. In Belgium this type of legislation was passed in 1934. Before that year banks had enjoyed almost complete freedom and there was no real banking legislation. However, a Royal Decree enacted on 22 August 1934 forced the universal banks to split up into deposit banks and holding companies before 1 January 1936. It was a reaction to the Great Depression, when, especially after 1932, some Belgian banks came into distress. By the Decree, banks were not allowed to hold bonds and shares, and they had to restrict their activities either to investment banking or to deposits and loan activities. The newly created holding companies became the most important shareholders of the deposit banks (Kurgan-van Hentenryk, 1995). Consequently, within a few years the banking system had changed profoundly. As banks were not allowed to hold stock in industrial companies and demand for short-term loans by firms was low, the banks were more or less forced to use their funds to grant loans to the public authorities (Kurgan-van Hentenryk, 1992: 328; 1995: 47). And whereas Belgium's banks could not hold stocks in firms, the opposite, that is, financial or industrial firms holding interests in banks, was not forbidden. As a result, the biggest banks became part of industrial or financial groups.

In Italy, where universal banking also was the dominant form of banking in the 1890s, the system changed during the 1930s. However, after the First World War universal banking first became even more dominant. After the war many firms were not able to repay their debts and banks decided to transform debt into shareholdings. Consequently these banks became important shareholders of firms. The system collapsed with the Great Depression and the state decided to intervene. The universal banks and their corporate shareholdings were taken over by the Istituto per la Ricostruzione Industriale (IRI), which was created by the fascist government in 1933. In 1936 a new banking law was enacted by which banks and industry were separated. Banks were allowed to grant short-term credit only, and their shareholdings in non-financial firms were severely restricted. At the same time, specialized institutes were created to grant industrial credit (Rinaldi and Vasta, 2014).

In contrast to the US, Belgium, and Italy, in most other European countries universal banking continued to be allowed. The major structural change in the German banking sector in this period was the creation of a national banking system by which commercial banks, special banks, savings banks and co-operatives were amalgamated (Hardach, 1995: 229). In Switzerland changes to the banking system started from the First World War onwards. In particular due to increasing international business the Swiss big universal banks

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increased in asset size (Cassis, 1995: 68), with some of them (Swiss Bank Corporation and Crédit Suisse) becoming almost as large as French and German banks. On the national market they became bigger than the cantonal banks. This growth came to an abrupt end during the Great Depression when, as in other countries, tighter state regulations were implemented. The Banking Act of 1934, however, did not forbid universal banking as had been the case in the US and Belgium. The main objective of the Act was to protect creditors by trying to avoid bank insolvencies. To this end a general framework for banking practices was established (Cassis, 1995: 70). Also the banks agreed on p. 122 ↳ voluntarily limiting capital exports in return for a law on bank secrecy. In France, large deposit banks, such as Société Général, Credit Lyonnais, Comptoir d'Escompte, and Banque Nationale de Paris, were nationalized just after the First World War. Moreover, the Banking Law of 1944 made a distinction between the activities of investment banks and those of commercial banks. These changes in the banking sector could be seen as a belated response to the problems of the depression of the 1930s (see Lescure, 1995: 334). Direct state ownership of major banks, which lasted until 1982, makes France somewhat unique and different from most other countries (another exception being Italy).

Interestingly Sweden, Denmark, and the Netherlands, all three neutrals in the First World War, experienced a banking crisis in the early 1920s (see for more details Jonker and van Zanden, 1995: 79–81) and they avoided a severe crisis in the 1930s. The reasons for the latter are less known. It is important to stress here that whereas in the Netherlands no legislation separating investment from commercial banking was enacted, banks themselves returned to trade financing and short-term credits again because they were concerned about liquidity (Jonker, 1991; Westerhuis and de Jong, 2015). The reorganization of the Dutch banking system between 1921 and 1924 might be the reason why the Dutch banks were less affected by the Great Depression. In Sweden, the banking sector was also severely hit by the depression of the early 1920s, and returned to commercial banking in the 1930s, characterized by a revival of deposit banking. In contrast to the Dutch case, in Sweden new legislation prohibited shareholding and share purchasing by commercial banks in 1934. This had to do with a new political situation after the First World War, which called liberalism into question. However, in practice many large commercial banks did not dispose of their shareholdings, but transferred them to affiliated investment companies that were indirectly controlled by the banks (Larsson and Lindgren, 1992: 351).

The English banking sector had changed from a rather competitive to a very concentrated one between 1880 and 1920 (Capie and Rodrik-Bali, 1982; Capie and Billings, 2004). In 1920 the Big Five, based in London, held around 80% of deposits and had about 10,000 branches (Billings and Capie, 2011: 197). This development has spurred much debate about the possible relationship between banking concentration, even called it a cartel (see e.g. Capie and Billings, 2004), and England's slow economic growth since the First World War (e.g. Ross, 1996). The unwillingness of English banks to take a more active role in financing troubled industries has been attributed to the banks' continuing concern about remaining liquid, resulting in banks focusing on short-term lending. However, this line of reasoning has been questioned more recently, by arguments that the British banking system offered ample support to its customers (Ross, 1996: 314; see also e.g. Ross, 1995; Collins, 1998; Baker and Collins, 2010). Moreover, the commercial banks represented only one source of external finance and operated in a much larger financial system. In other words, industrial investments were financed by institutions outside the banking system, such as stockbrokers and dealers. Due to specialization within the financial system 'the transfer of ownership or the provision of large amounts of capital was not a function of banks, but of specialist markets and institutions which existed precisely for those purposes' (Ross, 1996: 314). This specialization p. 123 ↳ in credits and investments contrasts to the wide range of services offered by the German universal banks. Research on the interwar period (see James, Lindgren, and Teichova, 1991; Cottrell, Lindgren, and Teichova, 1992) shows that indeed the British capital markets were different from the ones in continental Europe in the late nineteenth and early twentieth centuries. Thus the British banks were not like the German ones, which however did not necessarily mean that they performed worse (see for this conclusion also Ross, 1995: 274).

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Interestingly, the reverse has been argued: the fact that the Big Five were not universal banks, and their presumed conservatism 'helped them to avoid the fate of banks elsewhere' during the Great Depression of the 1930s (Billings and Capie, 2011: 211). Indeed England and Finland were the only two countries that did not experience a banking crisis in the interwar period.

In Japan the large number of banks was reduced by law in 1928 when the principle of one bank in one prefecture was adopted, giving the banks a monopoly in a limited area (Allen and Gale, 2001: 39). The essential decline in the number of banks was realized via mergers, which was facilitated by loans from the Bank of Japan. The state became directly involved in the financial system and increased that involvement even more in 1937 by a law that controlled loans to firms that were categorized as 'favoured'. This had to do with the development of the economy, which became 'increasingly dominated by investment requirements of militarism and imperial expansion' (Lazonick and O'Sullivan, 1997: 123). With the 1937 law the state's power became concentrated in a few *zaibatsu*. After the Second World War, when the Allied powers insisted on the dissolution or breaking-up of the *zaibatsu*, they met with little resistance from the Japanese people. However, because old-*zaibatsu* relations served as a basis for cross-shareholdings in the 1950s, a similar kind of institution emerged, but under a different name: *keiretsu*. The business groups or 'keiretsu' were centred around a former *zaibatsu* bank, known as main bank. The concept of main bank includes 'the relationships and practices between a company and its principal bank which range from the provision of financial services to share swapping and includes the presence of the bank's representatives on the company's board of directors' (Canals, 1997: 186). The main bank system in Japan is often compared to the *Hausbank* system in Germany, the main difference being that the *Hausbank* system developed in the private sector whereas for the main bank system the government was instrumental. The development of the main bank system went hand in hand with the cross-shareholding movement. As a result the Japanese system after the Second World War can be defined as a hybrid form: both the size of its financial markets and the development of its banking system has been substantial (Lescure, 2008: 323). At the same time, these banks could lend substantial funds to industrial firms, because the Bank of Japan lent at low rates to these city banks. Thus, once again the state played an important role in ensuring financial commitment to industry (Lazonick and O'Sullivan, 1997: 126).

To conclude, the interwar period clearly shows a break with the nineteenth and early twentieth centuries. Allen and Gale state that 'different reactions to instability associated with financial markets led to two broad types of financial system: market vs bank based systems' (Allen and Gale, 2000: 8). Divergence in financial systems p. 124 ↳ took off after a series of banking crises, which exposed the instability of the existing system. In many countries, the divergence was marked by increasing intervention of the state. This was part of a broader development: the liberalism and laissez-faire attitude, dominant in most countries during the nineteenth and early twentieth centuries, came under fire. The period of high international expansion and trade ended and was followed by a refocus on national economies. Banking activities were brought back to national economies. Countries such as Japan and Italy, although being exceptional cases, show how the banking sector was even transformed to support militarism (Japan) or fascism (Italy).

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The Resurgence of Universal Banks

The popularity of state intervention in the 1950s and 1960s, caused by the market failures of the Wall Street crash in 1929 and the following Great Depression in the 1930s, started to diminish in the 1970s when it became increasingly criticized. The banking sector was strongly impacted by structural changes in the world, most importantly the globalization of finance, financial deregulation, the creation of the European Union, and the developments in information and communication technologies (ICT). These led to increased competition on both sides of the bank's balance sheet. On the assets side, commercial paper and bonds markets gave large firms an alternative for borrowing from banks. And on the liabilities side, new technologies, such as the internet, and deregulation gave households and firms more choices (Rajan, 1998). The traditional intermediation function of commercial banks lost ground to (foreign) financial and non-financial companies, a process also known as financial disintermediation. These structural developments pressured banks to rethink their strategies. Before discussing these new strategies, the most important structural changes will be explained first.

Financial globalization was made possible by financial deregulation and new information technologies. The process started in 1971 with the collapse of the Bretton Woods system, the system of fixed exchange rates based on the US dollar. In response, many countries implemented a liberalization of capital movements. In continental Europe, a key driver for deregulation was the creation of the Single Market due to be completed by the end of 1992. For financial services this brought freedom of capital movements and the freedom for financial institutions to provide financial services and establish operations in all EU member states (Benink, 1992). In the US the deregulation process is commonly dated to the Supreme Court decision in *Marquette vs First of Omaha* in 1978, which set in motion the relaxation and partial removal of interest rate ceilings through a process of competitive deregulation among different states. It reached its culmination with the Riegle–Neal Interstate Banking and Branching Efficiency Act replacing the McFadden Act of 1927, allowing banks to expand in different states, and the Gramm–Leach–Bliley Act of 1999, which fully repealed the Glass–Steagall Act of 1933 and the limitations it had put on bank activities, notably the separation of p. 125 commercial ↳ and investment banking (see, for a summary, Sherman, 2009). In 1998 Japan followed by introducing the so-called Big Bang legislation.

One result of innovation was the emergence of high interest bearing instruments for investors. The market rates of these instruments were much higher than the rates commercial banks could offer. Consequently, commercial banks lost an important type of customer: the large depositors which formerly had been their main source of income. For firms it also became more attractive to borrow directly on the capital markets than from banks, due to the growth and internationalization of capital markets and the process of securitization. As a result, commercial banks' lending activities started declining as well (Canals, 1997: 277). In sum, the traditional function of commercial banks—accept deposits and originate loans—came under pressure.

The institutional changes challenged commercial and universal banks, because they lost part of their traditional activities, namely financial intermediation, to the market and to foreign and non-financial competitors. Accordingly banks had to rethink their strategies and they started focusing on consolidation by mergers and acquisitions, internationalization, and product diversification. We will now elaborate on these new banking strategies.

As mentioned earlier, in the US the restrictions of the Glass–Steagall Act were gradually relaxed. In 1987 Banker's Trust and Citicorp were among the first commercial banks to set up Section 20 subsidiaries to undertake underwriting activities. Many other banks followed as approval was given on a case-by-case basis. Also restrictions on bank's crossing state borders were gradually lessened. Thus the Riegle–Neal of 1994 set up a timetable for relaxing rules and between 1994 and 1997 states had the option to permit

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interstate banking. It allowed for mergers between the largest US banks, creating some enormous financial conglomerates. Thus J.P. Morgan, which had become a worldwide investment bank, merged with Chase, which had developed into a retail bank. Citibank, active in the international market and focused on worldwide consumer banking, added international investment banking activities by merging with Travelers (Slager, 2004).

In Japan three types of commercial banks had developed: city banks, regional banks, and foreign banks. The regional banks operated within a particular region and were specialized in providing services to local small and medium-sized companies and local governments. Most important, however, were the city banks, which had their headquarters in a large city and network of branches covering the country. Most of their lending was directed to large companies. In 1992 Japan had 13 city banks; four of them belonged to larger financial conglomerates offering a wide range of products and services: Mitsubishi, Mitsui, Sumitomo, and Fuyo. These city banks formed the centre of the Japanese main bank system, in which firms relied on direct bank finance and formed close relationships with a specific bank (Hodder and Tschoegl, 1984; Berglöf and Perotti, 1994). In the 1970s and 1980s Japanese banks showed a remarkable growth and became important players in the world's rankings. This growth was severely hampered when the Japanese financial crisis in 1991 ended this positive development. Many banks ran into problems when borrowers went bankrupt and many could not pay back their loans. Problems deepened by an important regulation proposed by the BIS in p. 126 1988, ↳ which increased minimum capital requirements. After 1993 all Japanese banks had to comply. However, meeting these requirements brought many Japanese banks into even more problems (Honda, 2002). Consequently, in the late 1990s, reforms known as the Japanese Big Bang were introduced to modernize the Japanese banking system, such as a gradual relaxation of restrictions on universal banking. Mergers and acquisitions between banks were allowed, resulting in the emergence of some large Japanese financial institutions.

In continental Europe many commercial banks diversified into investment banking in order to assist their large corporate clients to enter the money and capital markets. In so doing they increased their fee income compensating for the decreasing interest-income. European regulation further facilitated the diversification of commercial banks and consolidated the European model of universal banking. Thus the Second Banking Directive of 1989 permitted the development of bancassurance. Banks were allowed to provide insurance services, by either merging with or acquiring an insurance company or by creating their own subsidiaries in insurance. In the Netherlands, for example, structural supervision was relaxed by the end of the 1980s. It allowed for mergers between large banks and between banks and insurance companies. Four financial conglomerates emerged as a result: ABN AMRO, ING, Fortis, and Rabobank. They had a large international presence and provided a wide range of financial products and services to a wide range of clients (Westerhuis, 2008). Even in England the four commercial banks that dominated the English banking sector—Barclays, National Westminster, Midland, and Lloyds—had in essence developed into universal banks. They provided a wide range of banking services to consumers and firms, and they also offered underwriting and other services through wholly owned subsidiaries. In France involvement of the state after the end of the Second World War had been important; the government dominated the allocation of credit via an *encadrement* system. By restricting the expansion of credit, it put limits on the lending autonomy of banks. The state also created public agencies to allocate credits to specific sectors of the economy (O'Sullivan, 2007). By the end of the twentieth century the role of the state had become more modest though, whereas financial markets had expanded enormously. One of the exogenous reasons for this development was a systematic process of financial liberalization from 1984 onwards. In contrast, the German banking sector remained rather fragmented during the 1990s. Deutsche Bank, Dresdner Bank, and Commerzbank, the three largest commercial banks with branch networks over the whole country, were accompanied by cooperatives, savings banks, and Landesbanken.

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A change in the Belgian law in 1967 abolished all restrictions on bond holdings by which the conditions for banks considering shareholdings were made more flexible. Another important step was taken in 1990 when, due to stock exchange reforms, banks were authorized to participate in listed firms (Kurgan-van Hentenryk, 1995: 55). It is important to note that it was not only politicians who decided to deregulate the banking sector. The Association Belge des Banques, founded in 1936, also convinced public authorities to make the rules more flexible, in order to be able to grasp new opportunities and counter the increasing pressures felt by the banks. From the late 1980s, as p. 127 ↳ a result of deregulations the three big commercial banks created departments whose activities resembled those of investment banks and thus increased the share of non-interest income. Despite an increasing international presence, Belgian banks did not become as large as many other internationally operating banks; in other words they did not become global players. Kurgan-van Hentenryk (1995) sees in the absence of multinationals in Belgium and the increasing rise of foreign control of industry since the late 1980s the main reason for this development. Taxation on transferable incomes also led to a transfer of a large amount of savings to Luxembourg, The Netherlands, and Switzerland, so that for Belgian banks is was hard to attract sources locally (Kurgan-van Hentenryk, 1995: 61).

Thus a new type of universal bank with a large international presence and a broad range of activities developed (see Chapter 8 by Christopher Kobrak in this volume). The process by which these banks emerged often dates back to the late 1970s and is considered a reaction to the structural changes signalled here. However, in many countries (though not in Germany) the fragmentation in banking activities along segregation lines disappeared earlier than the 1970s. Already directly after the Second World War commercial or universal banks started to compete rather aggressively with savings and cooperatives banks on the home market for household savings. Households turned to banks for administering their rising wages, savings, and pensions, whereas the commercial banks were anxiously trying to strengthen their capital base for financing the reconstruction effort. Commercial banks, which before the Second World War often focused on firms and wealthy individuals, now also targeted private households, broadening their range of customers and increasing their types of financial services and products (diversification). On the other hand, cooperatives, traditionally focused on agri-businesses, also started broadening their scope to private households and small and medium-sized firms. For example, in the Netherlands the amount of debt increased enormously during the 1960 and 1970s, as a result of both mortgages and consumer credits, consisting of personal loans, revolving credits, and buying on hire purchase.

The financial conglomerates, as they may be called, are extremely large and in many countries they have become an important part of the economy, as is shown by their large share of gross domestic product (GDP). They are different from the universal banks of the late nineteenth century. They differ in types of activities and clients, as well as in organizational structure. The financial conglomerates combine hierarchy with autonomy and accountability at all levels, while the centre exercises control through explicit management tools, including budgeting and planning. By taking into account banks in the US and Western Europe, Kipping and Westerhuis (2014) argue that many banks had already become more managerial in the late 1960s and 1970s. The banks adopted a multidivisional organizational structure and in so doing the authors show that they started to move away from being traditional banking institutions to become more dynamic and aggressive. It might be that the roots of more risky behaviour in the banking sector, as exposed during the 2008 financial crisis, are related to these organizational changes. However, Kipping and Westerhuis also stress that more research is needed to fully p. 128 ↳ understand this process of change, by which for example also bankers themselves had to become 'managers' (Kipping and Westerhuis, 2014).

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Concluding Remarks

The chapter has shown that the dichotomy between market-based versus bank-based systems as the two main forms of financial systems is oversimplified. In particular, historical research has played an important role in nuancing the picture. Thus in many countries commercial banks developed into universal banks in the nineteenth and early twentieth century. Only in the interwar period did countries diverge into specialized versus universal banks, and since the 1980s a revival of the universal banks has taken place. This chapter has mostly focused on exogenous factors, such as formal rules and regulation, as an explanation for changes in financial systems. It should be stressed, however, that this is only part of the story. Individual banks and their bankers are important actors that decide on goals and strategies influencing the context they operate in (Kipping and Westerhuis, 2014).

An important characteristic of commercial banking is its close links with industry. The many studies of commercial banking in the nineteenth and early twentieth centuries made clear that in assessing their role in the industrialization process, one should bear in mind that for financing companies had options other than banks. Thus in the debate on the relation between banks and industrialization one often assumes that long-term credit was essential for industrialization and that this was seldom granted by commercial banks. However, it turns out that in many countries alternatives were present, such as retained earnings, family capital, wealthy entrepreneurs, and short-term loans that were rolled over or prolonged. These findings imply that in order to assess the financing of industry one should not just focus on markets or banks but on the financial system as a whole. This is an important consideration, because with the 2008 financial crisis the issue has become relevant once again. Policy makers are increasingly concerned with the financing relation between banks and medium-sized enterprises (SMEs). The current financial institutions focus mostly on more profitable investment and asset management activities, and are reluctant to finance SMEs, because of relatively high monitoring costs, it is argued. Large firms are no longer restricted to domestic financial institutions. Instead, due to financial globalization, they increasingly use foreign markets. However, for many modes of market finance SMEs are too small to utilize them economically. For them bank debt is still the most important source of external finance (Deeg 2009; Westerhuis and De Jong, 2015).

An important factor for explaining differences and nuances in the development of financial systems is the institutional context. Lescure concludes that financial systems 'are a result of a lot of different forces and the way these forces interact vary according to the context in which they operate' (Lescure, 2008: 338). Tilly argues that differences p. 129 ↳ in the political histories and structures of Germany, Great Britain, and the US in the nineteenth and early twentieth century seem to have been important determinants of the institutional differences in banking and how it developed over this period (Tilly, 1989: 206). Particularly interesting in this respect is the fact that commercial banks have been regulated separately from other financial institutions in most countries. This typical feature of commercial banking is not self-evident, however, and it has been the breeding ground for many questions. To what extent should commercial banking be regulated? Is competition or consolidation more efficient for commercial banks? Should commercial banking and investment banking be separated or combined? What about nationwide branching versus one unit banking? Behind these questions lies a more general debate on whether or not state regulation or market forces stabilize institutional structures (Cassis, 1996: 2). The 2008 financial crisis and its worldwide impact makes this debate all the more relevant again.

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