Financial Structure of the G-10 Countries: How Does the United States Compare?

The current debate over the U.S. financial structure can benefit from information on the financial systems of other industrial nations. Key public policy questions now facing the United States have been answered or are being addressed elsewhere in a variety of ways. Individual country approaches often reflect unique historical factors, yet broad international developments have increasingly influenced the financial systems of most nations—including the United States By examining different financial structures found among the industrial countries, we can visualize more clearly the options before us and discern where various proposals might place the U.S. market in relation to other markets.

Four central issues in the U.S. public policy arena provide a useful framework for comparing the financial systems of the Group of Ten (G-10) industrial countries [1] The first is the separation of "banking" and "commerce," since their integration can challenge the independence of a bank's credit decision process and stretch the reach of the public banking safety net. The second issue is the degree of separation of "banking" and "nonbank" financial services, as competition and technological change have led to innovations that make these services closer substitutes for each other. The third issue is the nature of official supervision, as overlapping activities and ownership ties of different types of financial institutions highlight the importance of regulatory convergence and consolidated supervision. The last issue is access to central bank account and liquidity facilities, since expanded powers and institutional affiliations may influence access to central bank services, including the final settlement of payments.

Recognizing that rapid changes and major differences in the financial structures of the G-10 nations would make an up-to-date description of their systems worthwhile, representatives of the G-10 central banks and staff at the Federal Reserve Bank of New York last summer began to compile data on the structure of each country's financial markets and institutions. This information, along with a series of country-specific papers prepared by analysts at this Bank, provided the foundation for this article.[2]

Separation of banking and commerce

The integration of banking and commerce can occur through commercial ownership and control of banks and through bank ownership and control of commercial firms. However, in most G-10 countries, banking and commerce are generally kept apart (Table 1). Indeed, in these countries it is by far the exception rather than the rule to find situations in which major banking institutions are owned and controlled by commercial firms. Instead, in the few countries where banking-commercial ties exist, banks typically own commercial enterprises or are affiliated with them through a common holding company with safeguards for the independence of the bank's credit decisions. Furthermore, those nations with sig-

[1]The Group of 10 includes 11 countries Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States

[2]The authors are indebted to many of their colleagues at the Federal Reserve Bank of New York who provided valuable research and comments The authors also are greatly obligated for information used in this article to a host of individuals from G-10 central banks, government agencies, and financial firms The authors are responsible for any remaining errors

nificant industrial-banking links have a long history of close ties between the two sectors. Even in these countries, possible risks associated with the integration of banking and commerce have been a matter of public debate.

Recent events in Canada illustrate current efforts to maintain and strengthen the barriers between banks and commercial firms, even in the face of widescale financial reform. Commercial control of Canadian banks has been prevented largely by a 10 percent limit on ownership by a single shareholder of a chartered bank's stock. However, this restriction did not preclude nonfinancial firms from acquiring large trust companies. The risks associated with such commercial-financial integration were discussed during the Canadian government's drafting of a proposal to permit the common ownership of banks, trust companies, securities firms, and insurance companies. Rather than allowing financial institutions with existing commercial interests to acquire banks, the present proposal eliminates this possibility and limits future commercial links with any large financial institution.

Table 1

Predominant Form of Banking-Commerce Integration in the G-10 Countries

	Commercial Ownership of Banks	Bank Ownership of Commerce	Common Holding Company*	Generally Limited Integration†
Universal Systems				
France			X	
Germany		X		
Italy				X
Netherlands				X
Switzerland				X
Blended Systems				
Belgium			X	
Canada				X
Japan				X
Sweden				X
United Kingdom				X
United States				X

*The typical form of integration is for a single holding company to have significant ownership interests in both banks and commerce

†In general, there are no controlling ownership affiliations between individual banks and commercial firms

Significant ties between banks and commercial firms are also generally not found in the Netherlands, Sweden, Switzerland, and the United Kingdom. It is noteworthy that in Switzerland and the United Kingdom, industrial-banking integration is not prohibited by legislation, yet commercial firms typically do not control banks. Similarly, Switzerland does not prohibit bank ownership of commercial firms. However, partly reflecting associated heavy capital requirements, majority ownership of commercial firms by Swiss banks is not common and typically has arisen out of troubled-loan restructurings.

The continued separation of banking and commerce in the United Kingdom reflects the Bank of England's ongoing policy of keeping them apart. As in Canada, this separation has been maintained in the midst of major financial reforms. Since this administrative policy apparently could be changed relatively easily, its continuation supports the observation that traditional barriers separating banking and commerce, where they exist, are not being removed. In fact, the Governor of the Bank of England has recently expressed a predisposition to oppose close associations between banks and commercial firms, citing the potential for conflict of interest, the risk of problems spreading from owner to bank (and vice versa), and an unwanted extension of the banking safety net.

Additional evidence of separation is provided by Italy, another country that has generally segregated banks and commercial firms despite the absence of specific legal restrictions.[3] This policy of separation, however, may be tested by the intended sale of government-owned banks to the public and by the recent lifting of a ban on new bank creation. These developments raise the possibility that commercial firms could purchase existing banks or set up their own banks if Italy does not formalize the separation of banking and commerce. However, the interministerial committee that sets financial policy guidelines endorsed the separation of banking and commerce and strengthened the Bank of Italy's administrative powers to maintain their separation. Furthermore, in recent speeches the Governor of the Bank of Italy has emphasized the dangers of commercial control of banking.

In contrast, ties between banks and industrial firms have long been prominent in Germany. Germany appears to be the only country where banks, through their equity holdings, exert significant ownership control over industrial firms, although direct ownership links are not unlimited. For instance, the sum of a bank's equity investments in excess of 10 percent of a commercial firm's capital, plus a bank's other fixed investments, can-

[3]The public sector holding company that controls the government's shares in three of Italy's largest banks has substantial industrial interests as well, but the banks are managed independently

not exceed the bank's capital. This limit, however, is made less binding by a bank's ability to value its assets at the lower of cost or market. The equity investments of German banks, along with both the proxy votes by banks of their clients' shares and the presence of bankers on most of the largest corporations' management committees, are seen as giving these banks great influence over commercial enterprises. The reverse, however, is not true—although nonbank ownership of banks is also permitted, in practice such links are not common.[4]

Germany's traditional integration of banking and industry has no doubt contributed to the corporate sector's relatively heavy reliance on bank loans for funding, even as many other countries' corporate sectors have shifted towards funding in the securities markets. And, despite the benefits often attributed to banking-commercial ties, offsetting concerns recently led the German Federal Monopolies Commission to recommend lowering a bank's permitted share holdings in nonbanks.

Although commercial firms within the G-10 countries typically do not control banks through majority ownership of their stock, there are a few examples of important banking-industrial affiliations through a common holding company. In Belgium, for instance, one holding company owns the nation's largest bank and controls a major share of Belgium's industries. Some of France's larger banks are also wholly owned or majority-owned by holding companies with sizable industrial connections. In practice, however, French bank holding companies have tended to keep their ownership participations in commercial firms well below 50 percent.

A recent draft proposal from the European Commission suggests the continuation of barriers between banking and commerce even as the European Economic Community (EEC) moves toward a genuine common market by 1992. According to press reports, the plan calls for a single EEC banking license that specifies approved activities and uniform prudential standards. The license would rely on ownership ceilings and bank capital constraints to limit a bank's commercial equity investments. With this EEC license, a bank would be free to establish a branch or subsidiary in any other member country. Although any nation could tighten or relax these restrictions for their domestic banks, no country could deny entry to an EEC-licensed bank that met these requirements. Thus, by including fairly restrictive equity investment limits, the plan does not envision widescale controlling ownership of commercial firms by banks

Links between banks and commercial firms in Japan are unique in that they are not based on majority stock ownership or holding company affiliations. Rather, a group of companies, which can include a bank, may be loosely affiliated through shared directors, long-term financial and management relationships, and small ownership interests in each other. Through these ties, banks and commercial firms can influence each other even if no single firm has a controlling share of another.

Although banking and commerce are generally kept apart in the United States, their separation is not absolute. While Federal Reserve member banks must adhere to tight regulations on industrial equity investments, some state-chartered banking institutions are subject to less restrictive limitations. Bank holding companies are also permitted to maintain up to a 5 percent interest in any individual commercial enterprise, although such holdings are not widespread. In addition, through the former "nonbank" bank loophole of the U.S. Bank Holding Company Act, commercial firms may own on a "grandfathered" basis a bank that voluntarily restricts its permitted activities. By limiting its activities, a nonbank bank escapes the definition of a "bank" and thus the associated ownership restrictions.

In summary, the separation of banking and commerce that characterizes the United States is the predominant pattern throughout the G-10 countries. Most G-10 nations are maintaining or strengthening barriers between the two sectors. Where links exist, commercial interests typically do not own banks, and in only a few countries do banks exert a strong influence on commercial firms.

Separation of financial services

Proposals that suggest greater integration of the U.S. financial system raise two questions. Which nonbank financial services are compatible with banking? Under what corporate structure should these services be integrated? All major industrial countries historically have had some type of officially sanctioned, if not required, specialization of financial functions For example, in addition to banks, most countries have specialized lending institutions that provide mortgages or long-term business financing, as well as institutions that operate on stock exchanges as brokers or market makers. Some nations still retain a high degree of segmentation of financial services. However, compared with barriers separating banking and commerce, those separating banking and nonbank financial services are not as rigid or extensive in most industrial countries.

To abstract from the institutional detail of the G-10 financial systems, it is helpful to define broadly what we mean by "banking" and "nonbank" financial activities. In this paper, "banking" describes deposit-based lending in a single entity. "Nonbank" financial services can be

[4]Commercial firms, such as automobile companies, do own banks that often provide specialized services such as consumer finance Nevertheless, such nonbank ownership only accounts for approximately 5 percent of German banking assets

thought of mainly as securities activities—underwriting, trading, and investing—and insurance underwriting. Although many different types of institutions are active in the G-10 financial markets, to facilitate international comparisons we can refer respectively to organizations specializing in one of these three general areas as "banks," "securities firms," and "insurance companies."

Two dimensions to financial integration can be identified One is the range of activities a financial institution is permitted to engage in directly, or "in-house." For example, a banking license might also allow a bank to provide directly certain securities services. As in-house powers expand and overlap, institutions of different types can compete directly with each other in more areas, and distinctions between them tend to blur The second aspect of financial integration is the extent of common ownership links between different classes of financial institutions, even if broad regulatory limits on their in-house activities are retained With cross-ownership capabilities, one type of financial firm might be the subsidiary of another, or different types of institutions might be affiliated through a common holding company. To some degree, financial integration through both overlapping powers and ownership links can be found in all G-10 countries.

At some risk of oversimplification, the extent and corporate form of financial integration distinguishes two broad categories of financial structures within the G-10 countries—the "universal banking" system and the "blended" system. In the universal banking system, financial integration has been achieved mainly with a single institution—a "universal" bank—directly providing in-house the widest range of financial services currently permitted among the G-10 members. Universal banking countries retain few of the significant restrictions on a "bank's" provision of "nonbank" financial services that still exist in other industrial countries. In contrast, financial integration in the blended system countries involves some mixture of ownership links between banks and nonbank financial firms as well as expanded in-house powers for banks.

France, Germany, Italy, the Netherlands, and Switzerland are best described as universal banking countries. In these nations a firm with a banking license may also provide a broad array of securities services and other financial activities. However, even in these countries, insurance underwriting is generally limited to separate insurance companies, although most of these nations permit some form of affiliation between insurance companies and universal banks. To be sure, every financial institution in a universal banking country does not offer every permitted service. Some firms may choose to develop expertise in specialized areas while others may limit their activities either to bypass or to take advantage of certain regulations. Nevertheless, the existence of large universal banks directly providing all banking and securities services distinguishes these nations from the blended system countries (Table 2).

Along with the United States, the blended system countries include Belgium, Canada, Japan, Sweden, and the United Kingdom. All of these nations maintain some degree of separation between those financial institutions providing banking services and those providing securities and insurance services. Yet every blended system country also permits at least some degree of overlapping institutional powers For instance, both banks and securities firms in all these nations participate in their governments' securities markets. Financial integration frequently takes place through affiliate relationships, contributing to the often complex structure of blended system financial institutions.

Table 2

Predominant Form of Financial Service Integration in the G-10 Countries

	Expanded Bank Powers*	Nonbank Subsidiary of Bank†	Common Holding Company‡	Degree of Integration of Banking and Securities Services§
Universal Systems				
France	X			High
Germany	X			High
Italy	X			High
Netherlands	X			High
Switzerland	X			High
Blended Systems				
Belgium		X		High
Canada		X		High‖
Japan		X		Low
Sweden		X		High‖
United Kingdom		X		High‖
United States			X	Low

*Single "universal" banks directly provide in-house all banking and securities services

†The typical form of integration is for banks to have wholly owned nonbank financial subsidiaries

‡A single holding company typically has significant ownership interests in both banks and nonbank financial firms

§Either through expanded in-house powers or through institutional affiliations

‖Financial structure liberalization recently has increased the integration of banking and securities services

Canada limits the overlapping of institutional powers, but financial integration is accelerating with the removal of cross-ownership restrictions. In 1987, Canadian legislation allowed banks to purchase and to create wholly owned securities subsidiaries. Current proposals also envision additional ownership links between all types of financial institutions, including insurance companies, through either subsidiaries or a holding company structure. Augmented in-house powers have been proposed as well, although important institutional distinctions are likely to remain. With these changes, the Canadian financial structure approaches the universal system from the standpoint of ownership and control.

Like the separation of banking and commerce, the form of financial integration in the United Kingdom appears to reflect policy more than legislation, although rules are becoming more formal. No laws restrict the activities, investment, or ownership of U.K. banks. Nevertheless, financial service integration in the United Kingdom—which, as in Canada, nears that of a universal system—has tended to take place through institutional affiliations rather than through an expansion of activities conducted in-house. For instance, a bank interested in underwriting corporate debt would typically do so through a securities subsidiary even though it could legally do so directly. Placing the securities activities in a subsidiary has been further encouraged by the capital rules issued by new self-regulatory organizations under the U.K. Financial Services Act. Insurance companies, however, are generally not affiliated with banks.

Financial integration in Belgium and Sweden is also greater than in the United States. In both countries banks may set up nonbank financial subsidiaries and may be linked to other financial institutions through a common holding company. Banks in Belgium and Sweden are also permitted to underwrite corporate debt and equity directly, although these markets are relatively small.

Next to the United States, Japan currently maintains the greatest separation of financial services among the other G-10 countries. In Japan, under legislation modeled after the Glass-Steagall Act in the United States, banks are prohibited from underwriting and trading corporate debt and equity, while securities firms cannot accept deposits and make uncollateralized commercial loans. Further segmentation exists within the banking sector, where different categories of banks are only allowed to hold certain types of assets and liabilities. Along with institutional specialization, Japan limits financial integration through ownership links, with banks and securities firms not permitted to own controlling interests in each other or to be owned by the same company. The common ownership of banks and insurance companies is restricted as well.

Within the United States, the bank holding company is the predominant form of large bank ownership. A bank holding company owns the shares of a bank and often other companies conducting banking-related businesses. The holding company usually centralizes the debt and equity funding of its bank and nonbank subsidiaries.

Outside the United States, a parent bank and a series of bank and nonbank financial subsidiaries make up the typical banking-finance group. Thus, rather than a holding company, an operating company—often a bank or bank-like entity—is typically the lead or parent firm. When the lead institution does not provide every financial service directly, additional activities are generally conducted through subsidiaries.

Holding companies, where they exist outside the United States, are used more to link banking and commerce than to integrate financial services. By virtue of the wide range of permitted in-house powers in universal banking countries, financial institutions in those nations do not need holding companies to place banking and securities activities under common control. In blended system countries that permit ownership ties between banks and securities firms—Canada, Sweden, and the United Kingdom—affiliations occur through subsidiaries more often than through holding companies, generally with a bank as the ultimate parent. Similarly, holding companies are not the primary vehicle for financial integration in Belgium, since banks there may conduct several in-house securities activities and may set up nonbank financial subsidiaries.

In the United States, the Bank Holding Company Act and the Glass-Steagall Act limit the in-house activities of banks and ownership linkages between banks and nonbank financial firms. Current proposals would permit greater integration, generally along the lines of the institutional affiliations found among the blended system countries, but under a bank holding company structure rather than through subsidiaries.

In summary, the United States, along with Japan, retains the greatest degree of separation of financial services among the G-10 nations. In other countries, the process of financial integration is well advanced. Banks historically have had broad in-house powers in universal banking system countries. In most of the blended system countries, financial integration is being achieved by expanding permitted affiliations between financial firms.

Official supervision

The proposed integration of banking and securities activities in the United States raises three broad policy questions related to the supervision of financial firms. The first is the extent of consolidated reporting and capital adequacy assessment, both at the financial firm

and the financial holding company level, since activities carried out by overseas branches, by subsidiaries, or by affiliates may affect the health of a bank or securities firm. The second is how to structure supervision to achieve consistent regulation across types of firms and types of businesses and still monitor the overall financial health of the integrated financial firm. The third is the extent to which a bank within a financial group is limited in seeking financial support from or providing it to affiliates

Consolidation

Supervision is said to be "consolidated" when all the entities in a financial group are subject to some degree of prudential oversight and the group as a whole is covered by standards that measure the adequacy of capital, liquidity, and management. Thus, consolidation takes account of the effects that the branches, subsidiaries, or affiliates can have on the health of a financial firm.

Over the last several years, bank supervisors in the G-10 countries have widely adopted the principle of consolidation in bank reporting requirements and in assessing bank capital adequacy Consolidation typically extends to securities and other nonbank activities carried out in-house by banks or by their subsidiaries (Table 3). Germany and Japan are partial exceptions, although in both countries the few remaining gaps are being filled. Germany excludes some subsidiaries in its consolidated reporting requirements but includes them in assessing capital adequacy Consolidated reports in Japan exclude some foreign subsidiaries, but the subsidiaries file separate reports The Japanese Ministry of Finance also has amended its bank capital adequacy measures to include a foreign subsidiary if it accounts for 10 percent or more of the firm's assets or profits This provision captures roughly half of the overseas subsidiaries of the city banks, Japan's larger banks. Moreover, both Germany and Japan are parties to the proposed international agreement on bank capital adequacy standards to be applied on a worldwide consolidated basis.

In the few countries other than the United States in which the holding company structure is used for joint ownership of banks and commercial firms, consolidation does not generally extend to holding companies. A holding company that jointly owns banking and commercial firms is subject to some oversight in Belgium, but not in France, and is not subject to capital requirements in either In Canada, where a holding company structure may soon be permitted for the common ownership of financial, but not commercial firms, supervisory rules for the holding company have not been finalized

While consolidation has been widely adopted in the supervision of banking, it is not as prevalent in the supervision of securities firms. This opens up a divergence of practices between universal system and blended system countries, and within most blended system countries. In universal banking countries, consolidated supervisory treatment applies to both banking and securities activities, since securities activities are usually carried out by a firm with a banking license or by its subsidiary. In blended system countries, however, the extent of consolidation for securities firms depends on whether or not they are affiliated with banks Securities subsidiaries owned by banks in Belgium, Canada, and Sweden are included in the reporting and capital adequacy assessment of the bank. This is also true in the United Kingdom, although the assessment of capital adequacy is somewhat different. The Bank of England computes the capital required by the securities regulator for the securities subsidiary, deducts this amount from

Table 3

Consolidated Reporting and Capital Adequacy Requirements of Banks and Securities Firms in the G-10 Countries

	Extent of Consolidation of Banking Activities		Presence of Similar Consolidation Requirements for Banking and Securities Activities	
	Full	Partial	For Most Securities Firms*	Only for Bank-Affiliated Firms†
Universal Systems				
France	X		X	
Germany		X	X	
Italy	X		X	
Netherlands	X		X	
Switzerland	X		X	
Blended Systems				
Belgium	X			X
Canada	X			X
Japan		X		X
Sweden	X		X	
United Kingdom	X			X
United States	X			X

*In universal banking system countries, banks are the principal providers of securities services

†Securities activities conducted directly in-house by a bank (in countries in which banks are not the principal providers of securities services), by a bank's securities subsidiary, or by an affiliate of a bank holding company

the parent bank's capital, and then assesses the bank's capital adequacy against the remainder. This is similar to the proposed approach for computing bank holding company capital adequacy in the United States should bank holding companies be permitted to own full-service securities affiliates.

Consolidated supervision is the exception for securities firms not affiliated with a bank. In Canada, consolidation of overseas activities in capital adequacy assessment is at the option of the securities firm. In the United Kingdom, securities firms are not routinely supervised on a consolidated basis, although U.K. authorities have shown an inclination to extend the principle of consolidated supervision beyond banking. In Japan, only the domestic branches of securities firms are included in consolidated reports. However, the Ministry of Finance also receives periodic reports from domestic and overseas subsidiaries, providing the Ministry with an overview of the firm's worldwide activities.

In the United States, banking and securities supervisors also differ from one another in their approach to consolidation. A bank reports its activities on a worldwide consolidated basis—including subsidiaries engaged in securities or other nonbanking activities. A bank holding company must also report its worldwide bank and nonbank activities on a consolidated basis. In contrast, the reporting requirements and capital adequacy assessment of a securities firm are not on a consolidated basis if the firm is not affiliated with a bank. Rather, the Securities and Exchange Commission (SEC) assesses the capital of the registered securities broker/dealer only. Thus, in the prevailing corporate structure in the securities industry, a holding company, which is not subject to regulatory oversight, owns a registered broker-dealer as well as other, unregulated, affiliates that can carry on a significant part of the group's overall financial activities.[5]

In summary, consolidated banking supervision is the norm throughout all G-10 countries. As a byproduct of banking regulation, securities activities are also supervised on a consolidated basis in the universal banking countries. In blended system countries, however, including the United States, supervision of securities activities is consolidated generally only when the parent is a bank. Nevertheless, some inclination toward consolidated supervision of securities activities is evident in other blended system countries.

The supervisory structure

Growing integration of banking and securities activities within blended system countries has increased the importance of coordinating domestic regulatory policies. Where regulatory authority is segmented mainly by type of firm (rather than by type of activity), as it is in the United States, financial integration raises questions about who sets the rules for firms engaged in a particular business, who applies the rules, and who, if anyone, supervises the consolidated firm when it is engaged in more than one activity. Greater international competition also creates a need for increased international regulatory coordination.

Functional supervision has been proposed in the United States as a way to allocate domestic supervisory responsibilities and to promote competitive fairness when financial firms of different types compete in the same business lines. It also presents a potential route for greater international coordination. Under functional supervision, the nature of supervision, including rules and standards, is based on the financial activity or function rather than the type of institution conducting the activity.

Coordinating domestic regulatory policies in most G-10 countries is simplified because the supervisory structure is less segmented than in the United States. Regulatory authority is extensively distributed between federal and state governments in the United States. In virtually all other G-10 countries, however, one authority is the chief supervisor of banks, one authority—most frequently, the banking supervisor—is also the principal or predominant supervisor of securities firms, and one authority is the insurance regulator. Moreover, in those countries with a small number of large financial institutions, the supervisory relationships can be very focused and informal.

At the same time, most countries have at least some areas of longstanding supervisory overlap. Thus, if the central bank is not the principal bank regulator, it usually has some supervisory role because of its broader responsibility for the liquidity of the financial system. In the securities markets, exchanges and regional authorities often provide rules and oversight.

In a majority of G-10 countries, a single supervisor is responsible for both banking and securities firms (Table 4). That primary regulator is either a banking commission (Belgium, France, Germany, Sweden, and Switzerland) or the central bank (Italy and the Netherlands). In these seven countries, the role of the central bank ranges from consultation to principal responsibility for carrying out supervision. Since the banking commission or central bank responsible for both banking and securities activities typically does not set different rules or capital standards for the two activities, functional supervision is not a broadly applied principle in these countries. Moreover, the capital rules and standards

[5]The reasons for this difference in approach are discussed by Gary Haberman in "Capital Requirements of Commercial and Investment Banks: Contrasts in Regulation," this *Quarterly Review*, Autumn 1987, pp. 1-10.

applied are typically geared to the risks of traditional commercial banking and generally do not explicitly incorporate the market-making risks of securities activities.[6]

In the United Kingdom, Canada, and Japan, regulatory segmentation is somewhat higher. These countries have separate supervisors for banking and securities activities. In the United Kingdom, the Bank of England supervises U.K. banks and firms engaged in wholesale money market activities while the Department of Trade and Industry, the Securities and Investments Board (SIB) and, under SIB oversight, self-regulatory organizations (SROs) are responsible for supervising firms engaged in securities activities. In Canada, banks are supervised by a federal regulator, the Office of the Superintendent of Financial Institutions (OSFI), and the Bank of Canada can require the OSFI to examine individual institutions. However, provincial authorities along with SROs supervise securities firms.

In Japan, the Ministry of Finance oversees both banks and securities firms, but the individual bureaus within the Ministry operate with some independence. The Banking Bureau of the Ministry of Finance is the principal supervisor of banks, while the International Finance Bureau oversees the banks' international and foreign exchange business, and the Securities Bureau oversees their government bond business. The Securities Bureau is the principal supervisor of securities firms. In addition to the Ministry of Finance, the Bank of Japan supervises banks and a number of securities firms, including the largest ones, in connection with their accounts at the Bank of Japan.

A few examples of functional supervision have appeared in the United Kingdom, Canada, and Japan as permitted powers of banks and securities firms have begun to overlap. Both the United Kingdom and Canada, which integrate banking and securities activities primarily through bank ownership of securities subsidiaries, are moving toward functional supervision, while retaining the principle of consolidated supervision for banking firms. In the United Kingdom, the Bank of England applies rules made by the SIB to banks' securities subsidiaries. The SIB in turn applies the Bank of England's commercial paper dealing rules to securities firms. This voluntary arrangement is meant to be a first step toward a pattern of functional supervision. In Canada, bank-owned securities subsidiaries are regulated by provincial securities authorities and are included in the consolidated supervision of the parent bank by the OSFI. The Canadian reform plans express the intention to apply functional supervision more broadly as financial integration in Canada proceeds.

Functional supervision is also evolving to a limited extent in Japan. As noted, the Securities Bureau already supervises the government securities activities of banks, with additional oversight from the Banking Bureau. As new domestic markets for instruments such as swaps and commercial paper have developed, both securities firms and banks have been allowed to deal in them, and the Ministry of Finance has expressed interest in common regulations. For example, both banks and securities firms are permitted to engage in the recently introduced commercial paper market under a single set of rules developed jointly by the Banking and Securities Bureaus. In other areas, however, the Ministry of

[6]Swiss bank capital adequacy requirements, however, contain detailed treatment of both banking and securities risks

Table 4

Regulatory Segmentation and Functional Supervision in the G-10 Countries

	Regulatory Segmentation for Banking and Securities Activities			Functional Supervision for Banking and Securities Activities
	One Principal Supervisor (One for Both)	Two Principal Supervisors (One for Each)	Multiple Supervisors	Degree of Current or Planned Use
Universal Systems				
France	X*			Low†
Germany	X			Low†
Italy	X			Low†
Netherlands	X			Low†
Switzerland	X			Limited†
Blended Systems				
Belgium	X			Low
Canada		X		High
Japan		X‡		Limited
Sweden	X			Low
United Kingdom		X		High
United States			X	Limited

*The Banking Commission, the principal bank supervisor, shares responsibility for supervising the securities activities of banks with the Stock Exchange Council

†In universal banking countries, banks are the principal providers of securities activities, so that the need to allocate supervisory responsibility has not spurred the development of functional supervision as it has in some blended system countries

‡The Banking Bureau and the Securities Bureau are both part of the Ministry of Finance, but they operate somewhat independently

Finance has continued to allocate supervisory responsibility along institutional lines Thus, a foreign banking subsidiary of a Japanese securities firm is supervised by the Securities Bureau (the regulator of the parent firm), rather than by the Banking Bureau.

The examples of functional supervision in the United Kingdom, Canada, and Japan have so far been modest both in number and in the scope of the activities covered. Functional supervision seems to have been facilitated by the use of separate affiliates for different activities. However, the limited experience with functional supervision in these countries and in the United States suggests that difficult practical problems arise in applying rules from one regulatory framework to institutions supervised within another.

Splitting supervisory authority along functional lines raises the question of oversight of the overall firm The United Kingdom has addressed this issue with the concept of a "lead" regulator An agreement between the Bank of England and the SIB assigns supervisory responsibility for the overall safety and soundness of the financial group to the regulator who covers the bulk of the group's business. In Canada, integration of banking and securities activities currently is possible only through bank ownership of a securities subsidiary, with the integrated firm subject to consolidated supervision by the OSFI. Canadian proposals would also allow a nonbank financial institution to own a banking subsidiary and a holding company to have separate securities and banking affiliates. The proposals do not yet specify, however, whether or not in all cases these financial groups would be subject to consolidated oversight, and if so, by whom.

In summary, regulatory segmentation is generally much lower in other G-10 countries than in the United States In the majority of these nations, banking and securities businesses are principally supervised by the same authority and the "lead" regulator is readily apparent. In Canada, Japan, and the United Kingdom, three G-10 countries where segmentation is relatively high, functional supervision is an emerging approach, but it has been applied to relatively few activities. The concept of a "lead" regulator to oversee an entire financial group has accompanied the development of functional supervision in the United Kingdom

Separating banks from their affiliates

In the United States, regulations governing the relationship between banks and their nonbanking affiliates have reflected certain policy concerns. These concerns are. ensuring competitive fairness, avoiding conflicts of interest, inhibiting the nonbanking activities of the bank holding company from draining resources from the bank, and preventing the extension of the bank safety net to nonbanking activities.

The holding company structure favored by many recent proposals is intended to promote these various goals and, more narrowly, to facilitate functional supervision. These proposals would tighten existing restrictions on bank lending to a holding company securities affiliate. They would also limit indirect forms of support such as bank lending either to the affiliate's investing customers to purchase securities, or to its issuing customers to pay interest or principal.

Some other G-10 countries have restrictions on bank lending to affiliates, but the restrictions appear to be aimed chiefly at maintaining the independence of a bank from its commercial affiliates. In Belgium, for instance, the supervisory approach tends to be strict on interaffiliate lending when the bank is owned by a holding company with substantial commercial interests. The bank must sign a protocol with the central bank covering lending to affiliates.

In the United Kingdom, transactions between banks and their securities affiliates are subject to few explicit restrictions, but the transactions receive close scrutiny from the Bank of England. In general, banks do not engage directly in underwriting and other securities activities, but own subsidiaries which do. A limited number of specific activities (for example, gilt-edged market-making) must be conducted in separate subsidiaries, and the parent bank must allocate (or "earmark") a portion of its capital to each subsidiary, but only an inadequate capital position at the bank would prevent it from supporting its affiliated securities unit. Furthermore, there are no formal limits on a bank's short-term lending to affiliates, and wholly owned subsidiaries controlled and funded by the bank, as well as any affiliate supervised by the Bank of England or another U.K. authority, are exempt from the Bank of England's large exposure policy. Indeed, the bank can, with sufficient justification, serve as the treasury for the entire financial group in order to realize the potential cost reduction of centralized funding. The Bank of England would then determine limits on bank exposures to affiliates for maturities up to one year on a case-by-case basis.

The financial reform plans in Canada would strengthen existing restrictions on "self-dealing," transactions with persons considered to be "non-arm's length" to the financial institution, including owners, directors, affiliates, internal auditors, and any businesses they control. Proposed rules to preserve the independence of the bank's board of directors would also limit the number of bank directors representing affiliated financial firms.

However, restrictions imposed by Canada on transactions between regulated financial affiliates within the

same financial group would be substantially milder than those on "non-arm's length" persons. The less restrictive framework is meant to allow financial firms to take advantage of the "synergies" created by affiliations with other financial firms. The Canadian reform plans would still limit asset sales and loans between holding company affiliates but would exempt wholly owned subsidiaries of a bank from even these restrictions. Since the financial reform will not require banks and securities firms to operate as separately capitalized firms under a holding company, banks could continue to own securities subsidiaries and thus have considerable freedom to move banking capital and funds to support the securities activities of the financial group.

In the United States, current regulations already enforce considerable separateness between a bank and its parent and between a bank and its affiliates within a bank holding company. These regulations strictly limit the size of credit extensions by the bank to its affiliates, require collateralization of all interaffiliate lending, and restrict the purchase of an affiliate's assets or securities In addition, to assure that the bank holding company can serve as a source of strength to the bank, the holding company must meet separate capital adequacy requirements. The bank's relationship to its subsidiaries, however, is not generally subject to the same limitations The bank's capital is at stake in a subsidiary and, absent special supervisory limitations, little impedes the bank from supporting a subsidiary by advancing it funds or acquiring its assets.

Proposed U.S. regulations would be more restrictive With few exceptions, they would prohibit a bank from extending credit to a securities affiliate, purchasing assets from the affiliate, and enhancing the credit of the affiliate's securities. Other rules would limit a bank's indirect support of the securities affiliate in the form of bank credit extensions to the affiliate's investing and issuing customers.

Thus, both current and proposed U.S. rules governing transactions between banks and affiliates appear to be more restrictive than practices overseas. In other countries, securities activities of banks are undertaken either directly in-house or in a subsidiary of a bank. Under either corporate structure, the bank can freely shift capital and funds from banking to securities activities. Few barriers prevent the bank from supporting its securities affiliate, and indeed, it is often presumed and expected that it will if circumstances warrant.

In summary, supervisory practices within the G-10 countries diverge in the major areas at issue in the integration of banking and securities activities in the United States. As in the United States, the principle of consolidation is widely applied to banks but usually not to securities firms unaffiliated with banks. In most blended system countries, securities firms face different reporting and capital adequacy standards depending on whether or not they are owned by banks, although in some nations an inclination toward extending consolidation to all firms is evident. Because most securities activities are conducted by banks in universal system countries, securities activities in those nations are supervised on a consolidated basis.

Functional supervision has not been applied broadly in any G-10 country, in most cases because supervision is not very segmented. In countries with a relatively high degree of supervisory segmentation, such as Canada and the United Kingdom, functional supervision has been applied on a limited basis to divide supervisory responsibilies, and both countries plan to extend its use.

Current and proposed U.S. rules diverge sharply from overseas practices in the separation of banks from affiliated financial companies. In this area, other countries generally do not impose the barriers to the movement of capital and funds among affiliates that currently exist in the United States. Differing philosophies about the ability to isolate a bank or securities firm from its affiliates or to confine the assistance of the banking safety net to banks may underlie the different regulatory approaches, although these philosophies are rarely laid out explicitly.

Central bank accounts and central bank lending

Two major policy concerns in allowing broader powers for U.S. financial institutions have been to protect the integrity of the payments system and to control access to central bank lending, as well as the broader banking safety net In all countries, access to final settlement in the payments system is linked to central bank accounts In the United States, all insured depository institutions, including thrifts, are eligible to open Federal Reserve accounts and to use Fedwire. All depository institutions also have access to central bank credit.

In the United States, the proposed separation of banking and securities affiliates within a single holding company is expected to restrict access to the payments system and to central bank lending to firms conducting only a banking business. In other G-10 countries, however, the securities activities of banks, whether conducted in-house or by a subsidiary, appear not to have prompted the same concerns about limiting access. Other nations do not segregate to the extent proposed in the United States those units of the bank carrying out securities activities from those that use the payments system and have access to central bank lending. No additional explicit mechanism specifically buffers the payments system and the lender of last resort from securities problems in an integrated financial firm, although moral

suasion may. In part, concern about building in such protection may be lower outside the United States because bank failures have been fewer in number.

In the G-10 countries, banks are usually the only institutions with direct payments system access (Table 5). Japan, however, is an important exception. The Bank of Japan has determined that a number of domestic and foreign securities firms are eligible for central bank accounts. The accounts effectively provide a basis for access to the Bank of Japan's payments system as well as for a potential borrowing relationship. For these reasons, the Bank of Japan has linked access to its accounts with Bank of Japan supervision.[7]

[7]Swiss finance companies have access to the payments system, but only the more regulated companies that take deposits have access to central bank lending In Italy and Belgium, some stock market firms keep accounts at the central bank for *securities* clearance but do not have access to the payments system or central bank credit In Sweden, some savings and cooperative banks also have accounts but do not have direct access to the payments system

Table 5

Access to Central Bank Payments Systems and Central Bank Lending in the G-10 Countries

	Access to Central Bank Payments System Limited to		Access to Central Bank Lending Limited to	
	Depository Institutions	Depository Institutions and Some Securities Firms	Depository Institutions	Depository Institutions and Some Securities Firms
Universal Systems				
France	X*		X	
Germany	X		X	
Italy	X		X	
Netherlands	X		X	
Switzerland	X		X	
Blended Systems				
Belgium	X		X	
Canada	X*			X
Japan		X		X
Sweden	X†*		X	
United Kingdom	X*		X‡	
United States	X		X	

*A small number of large banks have direct access to the final settlement payments system in France and the United Kingdom Similarly, in Canada, a relatively small number of depository institutions, including loan and trust companies, have such access

†Only commercial banks have direct access to the payments system

‡Only discount houses have routine access to central bank lending

In general, where payments system characteristics most resemble those in the United States, particularly in the development of real-time electronic payments, there has been no attempt to isolate banking activities from securities activities. Rather, one strategy has been to prevent overdrafts altogether (Switzerland), an approach facilitated by the large central bank balances of the Swiss banks; another strategy has been to restrict direct access to the central bank's payments system to relatively few large banks (France and the United Kingdom) or to the largest clearers (Canada).[8]

While access to central bank credit is limited in practice to banks in almost all G-10 countries, some Japanese securities firms have potential access, as noted, and Canadian securities dealers with inventories of money market securities have some access to the Bank of Canada's discount window. Only Germany, however, appears to have specific legislation that limits central bank lending to banks.[9] In theory, almost all central banks could legally provide assistance to nonbanks through discounting commercial bills or government paper, through outright purchase of securities, or through lending against collateral. Virtually all central banks in the G-10 are prohibited from unsecured lending, but the range of collateral acceptable by law—as distinguished from practice—in some countries extends to goods and almost any security or debt instrument. In all countries, the secured nature of central bank lending should protect the central bank from significant loss.

Nevertheless, the lender of last resort function is construed differently from country to country. In many countries in which securities problems could conceivably spill into the banking safety net, such as the United Kingdom and the universal banking countries of Germany, the Netherlands, and Switzerland, a considerable emphasis has been placed on private sector support for troubled institutions, with strong moral suasion from the central bank. In other countries, such as the United States and Canada, central bank lending, usually with significant help from private banks, has played an important role in providing temporary support for a troubled banking institution while the problem is worked

[8]In Canada, the final settlement payments system is owned by the Canadian Payments Association and administered by the Bank of Canada

[9]In the United Kingdom, routine access to central bank credit is limited to the discount houses, so that banks would not normally borrow directly from the central bank

out. Canada, however, is seeking to lay out more explicitly the functions of the lender of last resort and federal deposit insurance.

In summary, U.S. proposals to use the holding company structure and strict controls on interaffiliate transactions to isolate the payments system and the discount window from the securities activities of banks provide a layer of protection not found in other G-10 countries. With the exception of banks in the United States and Japan, banks that engage in securities activities in-house, or that own a subsidiary which does, face no specific restrictions on their access to the payments system or to central bank credit

Conclusion

Most G-10 countries maintain the strict separation of banking and commerce that characterizes the U.S. system. In general, significant banking-commerce ties are only found in a few countries with a history of such links. Even there the trend in the domestic policy debate has been to recommend reducing their intermingling. Commercial ownership of banks is not the predominant form of integration in any country. Furthermore, outside of Germany, bank control of commercial enterprises is not a prominent feature of any economy In nations allowing the common ownership of banks and commercial firms by a single holding company, regulatory policy is aimed at insuring the independence of the bank.

In contrast, the separation of financial services found in the United States has a counterpart today only in Japan, and the issue of separation is being debated there as well. Elsewhere in the G-10, some nations have long permitted a single institution to provide directly both banking and securities services. In other countries, recent legislation and regulations have expanded the integration of banking and securities activities through increased institutional powers or ownership affiliations.

The supervisory issues raised by the integration of banking and securities activities in the United States have divergent resolutions among the G-10 countries. Consolidated reporting and capital adequacy assessment have been adopted by banking regulators throughout the G-10 nations, but securities firms not affiliated with a bank are not generally subject to similar requirements. In countries with segmented supervisory authority, functional supervision has emerged as an approach for allocating responsibility among regulators in a limited number of activities, but it is not yet a broadly applied principle Where an extensive application of functional supervision is intended, as in the United Kingdom, it is not seen as a substitute for consolidated supervision. To preserve this type of supervision, the United Kingdom has introduced the concept of a "lead" regulator.

The treatment of transactions between banks and affiliated companies tends to be much less restrictive in other G-10 countries than under existing and proposed regulations in the United States. Moreover, those countries that have recently examined affiliate transactions have emphasized the benefits of fairly free movement of funds from a bank to its financial affiliates.

Similarly, financial integration in the G-10 countries has not been accompanied by measures to remove nonbanking activities from banking firms having access to the payments system or central bank lending. While most countries continue to limit such access to banks, Japan allows access to these services to some securities firms it supervises, and the Bank of Canada lends to some securities firms.

Despite the rich diversity of financial structures in the G-10 countries, extensive integration of banking and securities activities is common, except in Japan and the United States. Moreover, corporate structures and regulations generally allow banks considerable flexibility in funding and managing securities activities. Current U.S. proposals would bring the level of integration of banking and securities activities in the United States closer to the level prevailing within the industrial world. Nevertheless, proposed restrictions on affiliate transactions would preserve a greater separation between banking and securities activities than is currently found in most other G-10 countries.

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