
THE IMPACT OF FINANCIAL CRISIS ON THE UNIVERSAL BANK MODEL

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Abstract

Universal banks are financial conglomerates that offer simultaneously underwriting and insurance services and also act like commercial banks; this business model first seen at the end of the XIX century had experienced difficulties once first major financial crisis hit in early 1930'. In US their existence was marked by a series of strict regulations which didn't allow "too big to fail" model to develop; in the late 1990' it encountered a more lax legislation which culminated, in the current subprime turmoil, with the pinnacle of the type in order to accommodate the new challenges of financial globalization.

This paper tried to identify potential conflicts of interest within universal banking and find evidence of the means which generate them within institutions that offer multiple financial services and create possibilities of exploiting synergies and economies of scope.

It followed the evolution of the regulatory framework and the impact on the financial institutions' structure, trying to identify remedies to avoid and eliminate conflicts on the selected field. Using a series of examples, it found evidence of the channels through which these conflicts influence market's informational flows and substantiated the long term implications within financial markets.

Keywords: *conflicts of interest, universal banking, informational flow, Glass-Steagall Act*

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In the case of conflicts of interest that take place within the banking field, the accent was put on its organizational structure and regulatory framework. Until several years ago, due to the separation between different banking categories, each with its own regulation and supervision, this problem seemed solved; when the barriers between investment banks, commercial banks and insurance companies were lifted once the Sarbanes-Oxley Act was enforced in 2002, this issue was brought into light once again within US financial system.

Even though different types of financial institutions emerged as separate entities, throughout the time it became obvious that by simultaneously offering multiple financial services, economies of scope could be reached. Since their conception, when the cost of information was high, banks used their privileged position of having access to clients' books to counterattack the problems of adverse

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selection and moral hazard. In the absence of standardized accounting and rating methods, banks had an important advantage because the relationship with their clients provided them with detailed information regarding their financial statements. Once a company was given green light regarding a credit line, this would send a positive signal to the market; a company with good credit can borrow cheaper from the capital market.

Economies of scope can be found in the reputation of financial institutions; if a universal bank can use its good reputation in one field to gain business in another field, it will have an advantage over specialized banks. Economies of scope can also be found in the fact that information from insurance, brokerage and investment banking fields overlap taking into account the size of the data base regarding their clients. Confidential information regarding the credit lines and stock/bonds issues of their clients led to an increase of the quality of universal banks' data base but also led to a decrease of the costs of providing financial services. Taking into account that a series of activities serve different departments within a bank, there are several potential conflicts of interest²²:

- If the potential revenues within a department rise, there will be an incentive for its employees to distort information for their own clients advantage (e.g. issuers who are underwriting department's clients will profit from an aggressive sale, while potential investors, also bank's clients, expect for an unbiased advice);
- A bank manager can promote other bank's division products or can hide the losses of an unsuccessful issue by redirecting the funds to bank's trust accounts;
- A bank which granted a credit line to a company whose creditworthiness is not the best can encourage its underwriting department to issue debt for that respective company so that it can repay its loan;
- A bank can grant loans under the current market price to a series of investors so that the last ones to be able to purchase securities offered by an other division within the group;
- A bank can influence or force the client to work with an insurance company which is part of same group.

When, during the US financial crisis which started in 1929, one out of five American banks went bankrupt, the general public and the politicians considered that speculations made by banks were the main cause for the distress. In 1933 US Senator Carter Glass and Congressman Henry Steagall passed the law that carried their names which tried to limit the conflict of interest created by commercial banks offering clients consultancy in debt issue field. A series of conflicts were made public at that time following a public outcry so that banks had to choose between the investment bank and commercial bank status. This act increased Federal Reserve's control on

²² Crocket, A., Harris, T., Mishkin, F. S., White, E. N. (2003), "Conflicts of Interest in the Financial Services Industry: What should we do about them?", Geneva Reports on the World Economy 5, pg. 56

credit institutions and established Federal Deposit Insurance Corporation – F.D.I.C. (whose main purpose was to guarantee clients' deposits).

In 1956 the Banking Act was passed and it extended the restrictions imposed on banks (they could not engage in non-banking activities and could not acquire banks located on other federal states). Starting 1960's, banks started lobbying US Congress in order to gain access to municipal bonds market and in 1970's several brokerage companies started offering banking services to their customers: checking accounts, deposit account, debit and credit cards. There were several attempts in 1984 and 1988 of the US Senate to lift a series of restrictions imposed by Glass-Steagall Act but every time the House of Representatives issued a negative vote. In 1991 Bush administration, backed by US Senate and House of Representatives Banking Committees, tried to restate the issue, but once again House of Representatives repealed the request.

In December 1986, Federal Reserve, which was banking system's supervision body, reinterpreted Glass-Steagall Act's 20th Section (which forbade commercial banks to underwrite securities) by letting them to obtain maximum 5% of the revenues from investment banking activities. In August 1987, Alan Greenspan, a former director within JPMorgan, became Federal Reserve's chairman and indicated that he intended to raise the limit from 5% to 10%; this will not happen until January 1989 and, in 1990, JPMorgan became the first commercial bank to offer investment banking services. In December 1996, with the support of Alan Greenspan, a fervent supporter of financial system deregulation, Federal Reserve raised the limit to 25%.

In April 1998 a \$70 billions stock exchange between Travelers (an insurance company which previously acquired Salomon Brothers, an investment bank) and Citicorp (Citibank's parent) created world's biggest financial conglomerate in the most important merger in the history until that time. It was mandatory for the transaction to comply with the existing regulations (i.e. Glass-Steagall Act and Banking Act) which were conceived in such a way so that to prevent the creation of this kind of financial conglomerates (an insurance company, an investment bank and a commercial bank acting all together under the same group). At the time of conception, the merger offered the oversight authorities three options:

- Changing the existing regulations;
- Stopping the merger;
- Forcing the new created structure to give up the activities that were not in compliance with the regulations.

The management of the two institutions had to structure the merger in such a way so that the new formed company to comply with the banking laws and the last interpretations of the Glass-Steagall Act. If US Congress wouldn't have changed the legislation or loosen up the restrictions, Citigroup would have had a deadline of two years to sell Travelers' insurance division; thus the merger had place based on the presumption that the regulations will be changed.

In May 1998, the new regulations which tried to abolish Glass-Steagall Act passed the House of Representatives with 214 votes for and 213 against and in September it passed the US Senate Banking Committee with 16 votes for and 2 against. Despite this success, the proposal was almost rejected in the Senate hearings but White House support made it pass on October 22nd, 1999. Thus, after 12 attempts within the last 25 years, the Glass-Steagall Act was finally repealed, paying off those almost \$300 millions spent on lobby; the final variant was sign into law on November 4th the same year²³.

A conflict of interest arose immediately after when Robert Rubin, US Treasury secretary and a former co-president of investment bank Goldman Sachs announced that he accepted a vice-president position within Citigroup. Rubin, using the position held until that time, was able to decisively contribute to the repealing of the Glass-Steagall Act and the successful merger between Travelers and Citigroup. When he quit Federal Reserve there were suspicions that he contributed to that respective law repealing aware of the fact that he will join soon Citigroup team.

At the beginning of the XX century, the rapid technological changes led to the expansion of capital markets, new companies and financial conglomerates finding themselves in a quest for new sources of capital; the method was the new issuance of stocks and bonds. Financial institutions which wanted to hold a share of the new created securities market, organized themselves in such a way so that they could profit from the advantages of the economies of scope and scale. When the capital markets collapsed, the financial conglomerates which simultaneously offered consultancy services in investment banking, insurance and also acted as commercial banks had to face public outcry, being accused of exploiting conflicts of interest.

Starting 1890['], the creation in US of big industrial companies led to an exponential growth of capital demand which could be supported mainly by bond issuance. The size of the issues and the risk embedded made obsolete the choice of a single investment bank acting as a promoter for an issue thus leading to the creation of syndicated issues, based on a consortium of specialized banks. As commercial banks were prohibited in holding issuers' shares, insurance companies became the main investors in the new issues taking into account that they had steady liquidity flows. In US, the biggest insurance companies were closely tied to investment banks:

- New York Life had connections with JPMorgan holding in its portfolio important shares of railroad bonds underwritten by the last one;
- Mutual had important commercial relations with First National Bank;
- Equitable held in its portfolio railroad bonds underwritten by Harriman and Kuhn Loeb²⁴.

²³ Public Broadcasting Service (2006), "The Long Demise of Glass-Steagall", <http://www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html>, Accessed on April 26, 2009

²⁴ Crocket, A., Harris, T., Mishkin, F. S., White, E. N. (2003), "Conflicts of Interest in the Financial Services Industry: What should we do about them?", Geneva Reports on the World Economy 5, pg. 57

The connections didn't cover only bonds acquisitions, insurance companies being also one of the main liquidity suppliers of investment banks to whom they use to lend important amounts of money through their affiliates; the main connection was made at the managerial level: the managers of the insurance companies were partners within investment banks and the bankers had seats in the boards of insurance companies.

In a bull market, conflicts of interest were ignored, but when the capital market collapsed for the first time in 1903, in the quest for possible explanations, the issue of conflicts of interest caught public attention; institutional relations and managerial practices were revealed and the public and investors were surprised to see their dimension.

Dissemination of confidential information at that time raised a series of issues: if investment banks benefited from insurance companies and if the last ones profited from their shareholders. Insurance companies saw in syndicated issues an opportunity to invest in bonds but they weren't treated as members with equal rights, having only the possibility of purchasing bonds at the IPO's level, while some of their managers had the possibility of investing at preferential prices.

A conflict of interest was put on scrutiny at that time when a syndicated issue led by JPMorgan in behalf of International Mercantile Marine failed to subscribe entirely and the syndicate members were forced to buy the remaining issue. To hide the transaction, New York Life (a member of the syndicate) sold the bonds to JPMorgan on December 31st 1903 just to buy them later on January 2nd 1904; this operation so called "window dressing" was done solely to remove the bonds from New York Life's balance sheet at the end of the year and hide the failure of the issue. Some of the insurance companies' managers used the opportunity to protect themselves from losses due to uninspired investments. G. W. Perkins, New York Life's vice-president invested in a series of issues underwritten by the insurance company he was leading. When the issues failed to be fully subscribed, he sold to New York Life its share in order to avoid future losses²⁵.

A source of conflicts of interest was that of managers in one financial field holding positions in the board of companies from another field. Management structure and the transactions made by managers weren't made public but some companies had a shareholder structure based on the majority of one shareholder which led to a bigger probability of moral hazard occurrence, where the supervisor authorities and other shareholders weren't unable to monitor management activity.

Following those conflicts a series of regulations were enforced within the field (Armstrong Act in 1906) imposing a series of restrictions with the purpose of diminish the potential conflicts of interest:

- Banning insurance companies to perform underwriting activities;

²⁵ Wigmore B. A. (1985), "The Crash and Its Aftermath: A History of Securities Markets in the United States, 1929-1933", Greenwood Publishing Group, pg. 174

- Forcing insurance companies' managers to withdraw from banks' boards and vice versa.

After the First World War, US economy entered a growth period backed by a strong capital market mainly due to the new issuances of stocks and bonds in the technology field. Following this trend, the underwriting business met an exponential growth while the revenues from classic commercial activity remain steady; consequently banks started offering underwriting services to take advantage of the trend.

Initially, the underwriting business was performed by commercial banks through their internal departments in charge with bond trading. McFadden Act passed in 1927 which allowed banks to act as underwriters didn't lead to the development of bonds departments within commercial banks but to creation of a series of separate entities, whose main purposes was offering underwriting services²⁶. Even though they act as separate entities, their names were derived from the parent bank and often shared the same offices. Usually they were tied to the parent bank by one of the following methods:

- Each shareholder of the bank became shareholder pro rata of the new entity;
- The bank appointed several trustees to hold the affiliate's shares;
- The bank held entirely the shares of the new entity which was seen as an investment.

Following the new market structure development, the number of banks offering underwriting services grew from 62 to 123 between 1922 and 1931 while the number of affiliates grew from 10 to 114 within the same interval. The percentage of issues underwritten by independent investment banks fell from 78% to 55% between 1927 and 1929 while commercial banks' grew from 22% to 45% within the same interval²⁷.

Taking into account the severe recession and the capital market collapse, the solution of completely separating commercial banks from its affiliates seemed the best at that time in order to face investors demand for an increase market regulation; the public perception was that affiliates hurt banks and affect their reputation. The solution was later transposed in 1933 into what we know today as Glass-Steagall Act²⁸ which contained several sections, out of which some worth mentioned regarding conflicts of interest:

- Section 16 – allowed commercial banks to trade securities only in the name and clients accounts;

²⁶ Johnston V.B. (1983), "The McFadden Act: A Look Back", Federal Reserve Bank of San Francisco, Research Department

²⁷ Kroszner R. S., Rajan R. G. (1994), "The Role of Firewalls in Universal Banks: Evidence from Commercial Bank Securities Activities before the Glass-Steagall Act" Center for the Study of the Economy of State, University of Chicago, pg. 29

²⁸ The Wall Street Journal (1998), "Understanding How Glass-Steagall Act Impacts Investment Banking and the Role of Commercial Banks", <http://www.ratical.org/globalize/linkscopy/GlassSteagall.html>, Accessed on April 12, 2009

- Section 20 – banned banks to have affiliates who were offering underwriting services;
- Section 21 – banned investment banks in accepting deposits and commercial banks to engage in any financial activity with financial institutions that offer underwriting services;
- Section 32 – banned commercial banks in having representatives in investment banks' boards.

By developing a long term relationship with its clients, commercial banks hold confidential information not accessible to the general public, superior to those held by investment banks. Universal banks, by combining the two categories, are superior from the information production standpoint, which gave them a special status in underwriting field; following the created synergy, investors should be willing to accept a lower return on bonds underwritten by universal banks.

A commercial bank can exploit the superior information acquired during its course of business by providing funds to the clients with the highest creditworthiness and providing underwriting services to those with a not so good tracking record. When the market suspects that a commercial bank profits from exploiting conflicts of interest, the last one will get penalized by investors who will charge a higher return for the issues it underwrites. If lending and underwriting activities are performed within the same bank, the general public will not be able to recognize if there are conflicts of interest between those two departments. Creation of an entity separate from the bank will help improve public perception but at the same time will reduce economies of scope.

A series of studies²⁹ rejected the theory which stated that the issues underwritten by universal banks were penalized by investors by charging a higher return. As we can see in the below table, the percentage of the issues underwritten by affiliates grew between 1927 and 1929 from 12.9% to 41.4% while those underwritten by internal departments fell from 9.2% to 4.0% and investment banks' decrease from 77.9% to 54.6%; thus, investors saw universal banks as being the most capable to perform underwriting activities, with their volume increasing significantly.

Table no. 1
Underwriting services providers'
market share within 1928 - 1929

Financial type	1927		1928		1929	
Investment banks	4.567	77.9%	2.924	70.4%	1.586	54.6%
Commercial banks:	1.296	22.1%	1.229	29.6%	1.319	45.4%
Affiliates	755	12.9%	970	23.4%	1.204	41.4%
Internal departments	541	9.2%	259	6.2%	115	4.0%
Total bonds issues		5.863		4.153		2.905

²⁹ Kroszner R.S., Rajan R.G. (1994), "The Role of Firewalls in Universal Banks" Evidence from Commercial bank Securities Activities before the Glass-Steagall Act", Center for the Study of the Economy of State, University of Chicago, pg. 31

An analysis made on a series of industrial bonds within 1921-1929 period³⁰ showed that the average yields of issues underwritten by affiliates were smaller than those underwritten by universal banks' internal departments; the market considered that separation of different activities as a positive signal in the course of eliminating conflicts of interest.

Table no. 2
Underwriters issues' returns

Type of underwriter	Initial yield average	Initial yield median	Number of issues
Affiliates	2.02%	1.99%	328
Internal departments	2.37%	2.50%	113

Once the financial crisis hit in 1930's, the quality of bonds (in conformity with Standard & Poor's and Moody's rating standards) decreased for all classes of underwriters even though the affiliates issued, on average, better rated bonds; within the affiliates there were registered fewer cases of issues default, quantified both as nominal and quantity.

Still there was a difference between the issues underwritten by universal and investment banks: universal banks didn't look at small companies' issues which carried a bigger probability of default. Investors, not being able to spot conflicts of interest within universal banks, acted in conformity with Akerlof theory referring to the so called "lemon market": they tried to protect themselves against conflicts of interest by charging a discount to bonds issues. Ratings are good indicators of default probabilities of issues underwritten by universal banks but they are not reliable for those issued by universal banks' affiliates; universal banks tried to compensate this by underwriting only the issues with above average quality whose price are less sensitive to market fluctuation.

Despite the access to the bond market and information, commercial banks concentrated on underwriting smaller issues and, in time, their average size became even smaller. If a small issue is considered of having a size smaller than \$75 millions, then 31% of affiliate's portfolio consists on small issues while the proportion within investment banks portfolio was only 8%. This fact shows the important role commercial banks play within the financial system: helping small companies to raise capital.

One of the modalities used by commercial banks to gain market share is to offer clients credit lines, thing that investment banks weren't allowed to do. This brought back the issue of cheap credit lines: a bank finances a company which will reimburse

³⁰ Kroszner R.S., Rajan R.G. (1994), "The Role of Firewalls in Universal Banks" Evidence from Commercial bank Securities Activities before the Glass-Steagall Act", Center for the Study of the Economy of State, University of Chicago, pg. 31

the credit by raising capital with the help of bonds issuance, structure that increases systemic risk within the financial sector.

Under these circumstances, universal banks seemed to offer advantages for both supervisory bodies and shareholders:

- For authorities, big diversified financial institutions, even if look stable, they carry systemic risk. Funding via deposits is cheaper because a part of deposits are guaranteed by specialized institutions; this measure to protect clients can lead banks into taking bigger risks;

- For shareholders, a financial institution model whose investments aren't market-to-market raises suspicions taking into account that its portfolio can accumulate risky positions, which, in the case of using the "banking book" method, will not reveal the true risk embedded. UBS and Citigroup shareholders aren't happy at this moment (when their portfolios are wiped out by the current financial crisis) knowing that the universal bank model is still valid just following the simple argument that both institutions are still standing.

Table no. 3
The benefits vs. risks of the universal bank model³¹

Benefits	Risks
<ul style="list-style-type: none"> - using deposits taken in underwriting activity; - revenues diversification; - increased synergies: <ul style="list-style-type: none"> • leads to costs cuts; • opportunities of "cross-selling". 	<ul style="list-style-type: none"> - swapping risks to activities with bigger risk aversion; - mergers have inherent integration difficulties; - the size of the new created financial conglomerates represents a problem itself.

The benefits of the universal bank model are obvious to investment bankers that operate with risky and volatile trading positions and for whom the current market turmoil represent a serious threat (at the beginning of 2008 they reported a leverage of 30 while commercial banks' was only 11)³². The constant revenues of commercial and retail divisions can compensate the losses recorded by underwriting activities; this model has also the possibility of offering cross-selling services as a potential source of additional revenues. Banks that offer at this moment these kind of services are "one stop shops" where clients can have access too all services within one location. The model can bring benefits through synergies, not just by boosting

³¹ S. Sankar (2008), "Is It Time To Embrace The Universal Banking Model?", <http://www.dailymarkets.com/stocks/2008/09/25/is-it-time-to-embrace-the-universal-banking-model/>, Accessed on March 26, 2009

³² Brown A. (2008), "The End of An(other) Era", Bullish Bankers Magazine, <http://www.bullishbankers.com/the-end-of-another-era/>, Accessed on March 26, 2009

revenues, but by cutting costs also (UBS claims that 10-15% of its market value was created by the group's synergies, with CHF 2.5 billions in extra revenues and just CHF 1.5 billions in expenses)³³.

A major risk is implied by the merger of two distinct activities, especially in the context when banks found easier to acquire small local banks or regional entities; the problems they can face can range from the technological ones to the ones regarding corporate culture. The "too-big-to-fail" model seems over now in the actual market conditions when banks are nationalized in order to avoid bankruptcy due to their exposure on subprime market (diversification means nothing when the correlation tends to one). At this moment investment banks will make a mistake if they will not choose to transform into commercial banks which, aside from steady clients flows, will bring a loosen supervisory from the authorities bodies.

The 2008 financial crisis revealed the deficiencies of different banking models. Trying to face subprime crisis, the biggest independent investment banks gave up on their business model either by bankruptcy or by their sale to a universal bank. The below graph shows how US banks evolved in the last century; it can be noticed that in 2008, even though a decade ago the separation between the commercial and investment banks was lifted, market development determined the extinction of the last ones. Is interesting to observe that the changes that took place in US financial market were influenced by the major crisis from the last century:

- The Great Depression in 1930's;
- The financial crisis from 1997-1998;
- The subprime crisis which started in 2008.

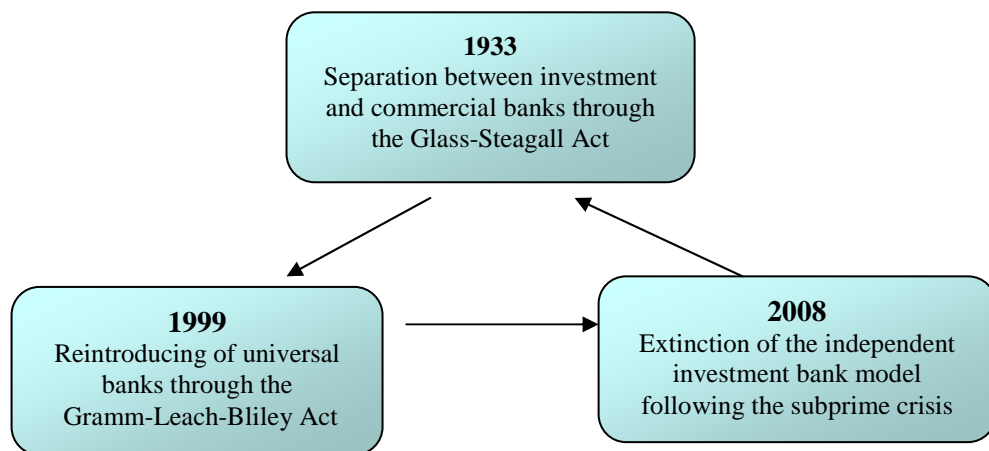


Fig. no. 1
The evolution of US banking model³⁴

³³ Slater S. (2008), "UBS universal bank model breaks, rivals defiant", Reuters News, <http://www.reuters.com/article/ousiv/idUSL.C49736620080812?sp=true>, Accessed on March 12, 2009

It is a myth that the deregulation of US financial markets failed and that new regulation within the field are necessary; beside the healthcare system, financial system is the most regulated field of the US economy³⁵. There was not even a single type of activity that managed to avoid regulatory oversight; in US there were several governmental bodies in charge with regulating financial markets (e.g. Federal Reserve, Securities and Exchange Commission, Federal Deposit Insurance Company etc). Certainly regulators carry a part of the blame for the current financial turmoil, but for sure lack of regulations is not one of them.

One of the most affected by financial crisis was UBS which decided in middle of 2008 to separate its investment banking unit (responsible for most of the losses connected to subprime lending) and the wealth management unit from the rest of the group; its strategy to offer multiple financial services within the same group (e.g. retail, underwriting, wealth management, mortgages and fund management) didn't have the expected results.

In May 2008, following numerous claims from investors who lost their savings in the financial crisis, Vikram Pandit, Citigroup CEO, stated that "...we have offices in 106 countries and we strongly believe that the most adequate business model at this time is that of the universal bank". On the other hand, UBS chairman, Peter Kurer, stated the same year in August that "... looking retrospectively we discovered the weaknesses associated with the universal bank model"³⁶.

Looking at the statements above the following question arises: "who is right and who is wrong?" The problems identified by UBS refer mostly to its incapacity of properly assessing the complexity and the risk embedded in its securities portfolio while a shareholder of Citibank stated that "... in the last ten years we had 41 chances (i.e. 41 quarters) to notice that universal bank model isn't paying off"³⁷. UBS didn't have a clear picture of the risks and didn't benefit from an adequate supervisory oversight which in the end led to a separation of its businesses. Is not the model that is responsible for the losses faced during the crisis but its management's inefficiency; the crisis didn't do anything but to bring into spotlight a series of deficiencies at the management level. To make a parallel between the strategies adopted by UBS and Citigroup, blaming universal bank model as a business model is like blaming the car and not the driver for producing an accident.

³⁴ Demirgüç-Kunt A., Huizinga H. (2009), "Bank Activity and Funding Strategies: The Impact on Risk and Return", European Banking Center Discussion,

³⁵ O'Driscoll G. P. Jr. (2009), "Lessons from the Subprime Crisis", Cato Policy Report

³⁶ Kiviat B. (2008), "Is universal banking over? Should it be?" Time Magazine, http://curiouscapitalist.blogs.time.com/2008/08/12/is_universal_banking_over_shou/, Accessed on March 12, 2009

³⁷ An Investment Banker's Take On Life (2008), "Some Thoughts on the Universal Banking Model", <http://www.investmentbankeronlife.com/2008/08/some-thoughts-on-universal-banking.html>, Accessed on March 13, 2009

Universal banks are market's answer to the financial needs of global corporate clients; this model cannot be blamed because its employees took additional risks in their quest for profits. Universal banks have the role of:

- Reduce the fragmentation in financial intermediation;
- Ease companies' access to capital resources;
- Enhance economies of scale;
- Reduce the cost of financial flows within banking system;
- Promote a better management of financial flows.

In the case of universal banks, the accent was put on the reduction of the degree of regulation with the purpose of gaining economies of scope without inducing the incentive to exploit conflicts of interest. This was a natural step because, in the case of US financial system, the Glass-Steagall Act represented an extreme remedy for eliminating conflicts of interest, through a complete separation of activities.

There are several modalities that can constitute remedies for the conflicts of interest within universal banks, as following:

1. separation of activities

The gains from economies of scope and the potential costs implied by conflicts of interest depend of the degree of separation and the organizational structure. There are three degrees of separation:

- separation of internal departments;
- creation of an entity affiliate to the parent bank whose object of activity will be offering underwriting services;
- banning all other combinations of activities under any organizational structure.

Complete separation removes any conflicts of interest but at the same time it removes also any benefit of economies of scope. Glass-Steagall Act provisions introduced complete separation leading in time to a reduction of US bank competitiveness. In time, this determined authorities to allow the establishment of affiliate entities with their own management and accounting standards; this change was implemented effectively by the Gramm-Leach-Bliley Act in 1999. This degree of separation is not a warrant of affiliates' independence from the parent bank because:

- business strategies are conceived at the group level;
- banks have the interest to protect affiliates fearing that a weak reputation of the last ones will affect group reputation;
- banks can support affiliates through loans, exchange of information flows and services.

2. solving the issue of managerial compensation

The possibility of US financial managers before 1933 to participate in their own name, through a series of partnerships, to syndicate loans (the only purpose being solely the profit) created an incentive for exploiting conflicts of interest. Managers'

compensations weren't tied to company's performance and allowed them to obtain extra revenues without a proper transparency towards the shareholders.

A conflict arises just from the fact that managers and shareholders have different time horizons regarding their expectations; while shareholders look at company's long term evolution, managers follow target prices, so if a division will produce superior revenues, it will be preferred over other departments.

3. enhancement of the degree of transparency in information dissemination

Empiric evidence showed that commercial banks were repaid for their capacity of performing other activities different from the standard ones (i.e. lower returns required by investors in bonds underwritten by commercial banks). Market and supervisory agencies' capacity to adequately monitor financial institutions depends also on the quantity of information the last ones are able to disclose. Relationships between affiliates and parent banks should be made public in order to eliminate any suspicion regarding the exploitation of conflicts of interest (in the case of merger and acquisitions this disclosure is not recommended as it may give competition an advantage and jeopardize the whole process).

In the last period, regarding the control of the risks incurred by financial activities, the accent was put on monitoring the operational risk; a bigger weight was given to banks' internal control procedures and managers' compensational structure, concentrating on identifying activities and procedures that favor exploitation of conflicts of interest.

Conclusions

The main issue raised by conflicts of interest for capital markets is represented by the reduction of information flows in the system which makes difficult solving the problems of adverse selection and moral hazard and determines a part of financial flows to be channeled to unproductive investments. The existence of conflicts doesn't imply necessarily a reduction of information flows because the incentives for its exploitation can be insufficient; when conflicts are obvious and perceived so by the market, their exploitation will imply a reputation risk for the respective company whose demand for its services will decrease, thus its profitability.

On the long run, losing reputation represents a risk big enough for the company to try to avoid but on the short run it depends only of the company's transparency and its internal compensational structure. Universal banks have interest to sell securities issued by the companies that experience financial difficulties because in this way the companies will be able to repay their debt towards the bank and the bank will earn additional fees.

Financial markets have the tendency to self regulate and there is evidence in this respect; as we noticed, the market penalized accordingly the conflicts of interest within universal banks: issues underwritten by bonds department within commercial banks were perceived as less attractive by investors comparing to those underwritten by affiliates. Is to be remarked that market adjusts itself to the current global

conditions but it should be mentioned that the solutions are not yet applicable because there is a delay between the moment when the problem is identified and the implementation of the solutions. Conflicts of interest are opportunities to exploit the excessive growth of capital markets, but they aren't the cause of financial bubbles. There have been several moments during history characterized by speculative bubbles and which were marked by changes in regulatory framework:

- 1929-1932 – US Great Depression which led in 1933 to passing the Glass-Steagall Act and marked the complete separation between the investment and commercial banks;
- 1998 – the financial crisis from Asia and Russia and the bankruptcies of some US hedge funds led to the repealing of Glass-Steagall Act;
- 2009 – US subprime crisis put universal banking model into spotlight and marked the extinction of the independent investment bank model.

Conflicts of interest can be eliminated by a complete separation of different types of financial activities but this can induce an additional cost on financial intermediation by reducing economies of scope. Passing Glass-Steagall Act after the financial boom of 1920's was an excessive response to market problems, response that brought along the time a significant cost for financial intermediation.

We can conclude that the market, when there is evidence of conflicts of interest, can act to control them by using a series of methods that can start from simple sanctions (losing reputation and future business) and finishing with pecuniary penalties. It is to be remarked also that market solutions work on the long run while those imposed by supervisory authorities function only on short term; on long term they jeopardize market's efficient development and its possible solutions to the problem.

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