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REDESIGNING THE FINANCIAL SYSTEM: A PUZZLE OF THE INSTITUTIONAL CHOICE AND CAPACITY BUILDING?

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Abstract. *The paper analyses the generally adopted classifications of the financial system. Financial systems are classified, in this paper, as either Market-based and Bank-based. However, many subgroups and the differences amongst them were pointed out. Although these differences may look to an outside observer minor and unimportant, at the very bottom line national differences may well influence the overall structure of the financial system, and create a hybrid solution. Although both German and Japanese financial systems are generally classified as Bank-based financial systems, differences amongst them are significant and the role of banks somewhat different. The paper does not deal with the area of financial system efficiency, but focuses on the main concepts of organisation and their major characteristics and features.*

1. INTRODUCTION

The processes of social transformation re-opened the question of institutions building and has raised, at the same time, many questions to which classic finance literature could not find answers or was believed that that these problems have long been solved (*Cf.* Sevic, 1996a). The existing 'transitional' literature addresses either different prospects of changes or describes the results made in different transitional countries (see: Sevic, 1999a). At the same time there is limited literature addressing the development of the financial system from the new institutional economics' point of view. This is a normal consequence of the fact that financial theory has been mainly dominated by neo-classical scholars. Moreover, neo-classical theory introduced some good concepts to economic thought (principal-agent theory, rational expectations, theory of contracts) but, with the passage of time, it became obvious that it was necessary to focus on the real economic problems from another rather different prospective. The idea of a perfect competitive

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market lost its credibility when we realised that a social transaction imminently induces transaction costs and when the concept of bounded rationality was fully endorsed. This paper tries to contribute to the (neo-)institutional theory of financial architecture.

First, our point of departure are the social institutions. They, ostensibly, provide individuals (including defined legal persons) with the specific benefits of predictability of others' behaviour and imposes "specific costs, in return."[1] These costs are usually seen as a limitation of (absolute) freedom of members of society. The quality and quantity of benefits offered from social institutions create social satisfaction in members of society and stability and social credibility on the side of institutions. This credibility, from a technical point of view, can be seen as enforceability. Namely, in a democratically based society the institutions that lose their credibility cannot be enforced without the additional social cost imposed. So, the institutions are the legal, administrative and customary arrangements for regulated human interactions (Pejovich, 1995). Their repetitive characteristic is of utmost importance. The provision of repetitive and/or predictive human behaviour leads to social security and harmonised human groupings. Since these institutions are the framework for future human actions, their efficiency is to be measured with reference to the cost that they incur.

Although neo-classical theoretical economic frameworks (partial and general equilibria positions) tend to assume the absence of transaction costs, everyday life proves this assumption false. Firstly, institutions change over time, and second the protection (and maintenance) of the system which once was set (as an order of the rules for the social game) is highly costly. Subsequently, institutional change is even more costly. In this sense, transaction costs are to be interpreted as the costs of all resources required to transfer the property rights from one economic agent to another.[2] Consequently, positive transaction costs prevent resources from being used more efficiently. Therefore, the outcome of institutional change depends highly on the social ability to force economic agents who can produce at lower cost to do so (Pejovich, 1995, pp. 40-43).

An aim of this paper is to (re)address the issues of financial system design and, subsequently, its re-engineering[3], taking into account the experiences and theoretical observations on the issues supported by the new institutionalist theory. Assuming that social institutions are created to reduce the unpredictability of human behaviour, we will explore some of the issues of different choices that can be made in financial system design. On this occasion only formal institutions are tackled, leaving informal institutional forms to be researched at a later date. We consider market-based and market-based financial system from *a corporate governance standpoint*, and observe their relative place in the economy within which they operate. This leads us to the (in)definite set of choices available at the outset of financial reform. But, the sets are not, by any means, limited.

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[1] "Institutions are rules of the game in a society, or, more formally, are the humanly devised constraints that shape human interactions. In consequence they structure incentives in human exchange, whether political, social or economic" (North, 1990, p.2.)

[2] Usually, the transaction costs include the costs of executing exchange and the costs of maintaining the institutional set up. Some studies have shown that by freeing resources for alternative uses a reduction in transaction costs increases the extent of exchange and production. (Wallis and North, 1986)

[3] About the re-engineering concept in Banking, see: Allen, 1994

2. MARKET-BASED *VS.* BANK-BASED FINANCIAL SYSTEM

Financial systems are traditionally a national category, but some common characteristics can, relatively easily, be found. The classical structure of the contemporary financial system comprises: 1) central monetary authority, 2) banking system (different kind of banks and other financial deposit taking intermediaries), 3) financial markets and 4) financial instruments (see: Sevic, 1999a). All these components have common theoretical characteristics, although they are, generally, differently defined in a particular financial system. Depending on which component of the financial system has higher relative importance the financial systems are classified into different groups.[4]

Theory generally recognises two types of financial systems: 1) bank-based (banking-based), and 2) market-based (securities-based) financial system. The first is connected with the German/Japanese experience, while the latter with the Anglo-American practice. The strategic choice between these two possible alternatives is crucial for the financial structure design in a transforming economy, although in advanced economies the differences are sharper in theory than in practice. In a bank-based financial structure greater emphasis is on financial intermediaries (especially banks), and their role is predominant, while financial markets play a supplementary role. In this model the relationship between the supplier of funds and the user of funds, typically a bank, or other financial intermediary is much more direct and closer. This closer relationship usually strengthens the banks' sole equity holding in a firm which enhances control and commitment. It is believed that this kind of consolidation of ownership allows the bank to influence the management of the firm (Udell and Wachtel, 1995). This model allows a bank to invest funds directly in other economic subjects in the real or financial sector of the economy. Simply by performing this activity banks, as a specialised financial agent, control closely the performance of enterprise management. It has been noted that this approach helped fast and successful privatisation in Eastern *Laenders* in the Federal Republic of Germany (Fels and Schnabel, 1991, pp. 22-24). In this model problems concerning information abilities arise. Some studies have suggested that the bank has insider information about a client and obtaining it is only possible through close relations with the bank. In such a kind of financial system there is a general lack of publicly presented information.

The bank-based system is characterised by the dominance of a few large universal banks involved in close relationships with industry. In this system pension funds and similar types of institutional investors do not exist. From an organisational point of view this concept is somewhat limited with regard to the set of participants. Limited publicly accessible/available information is simply a direct consequence of particular accounting rules and practices, as well as specific relations between firms and banks. The concentration of ownership is extremely high, therefore acquisitions and take-overs from outside investors are very rare, and the stock market does not play an important role for corporate control. The banks' presence is visible everywhere within the firm: on the board of directors, on the supervisory board... Simply, the bank-based financial system is highly concentrated, so the role of financial intermediaries, especially banks, is very important (Grosfeld, 1994, p. 6). Consequently, because the bank is both lender and investor, risk-

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[4] See institutional features and theoretical implications of different financial system concepts in Allen and Gale, 2000

shifting problems associated with debt financing might be less important (Chirinko and Elston, 1996).

We have presented above some general characteristics of the bank-based financial system, and we are now to compare some specifics of the German and Japanese bank-based financial system. The German financial system, which is treated as a 'blueprint' for the bank-based financial system, is really based on a bank credit thus the stock market is poorly developed. The German financial system centres itself around three large universal banks, which are closely linked to industry. As noted above, the banks own a substantial amount of individual equity, as well as acting as proxies for small investors. Investment banking enables enterprises to gain access to other sources of capital through the intermediary of banks. When the bank is also a shareholder, it is argued that the bank is more likely to pursue actions which enhance the overall return on capital. In this model a bank controls managers on two main grounds: as a creditor, and as a shareholder. The 'big three' (*Deutsche Bank*, *Dresdner Bank*, and *Commerzbank*) have 65 per cent of seats in Companies' Supervisory Boards and Boards of Directors (Carson, 1990, p. 603). The high degree of concentration of corporate control, together with legal safeguards, written into company statutes, make hostile take-overs extremely rare. Only two have occurred in post-World War II Germany. So, as a consequence of a system set in such a way, between banks and enterprises, there exist long-range forms of co-operation, which exceed the framework of bank participation in enterprise management and has spread to the provision of business consulting and - auditing control. Banks also finance new business initiatives and play an important stabilisation role. Other groups of banks can form consortia to rescue companies in financial difficulties. While there is a high concentration of banks at federal level, banking at local levels is extremely decentralised and it is relatively easy for SMEs to obtain funds from co-operative banks (3,151 in total), and regional banks (199 in number).[5] The above holds also at local level, i.e. local and regional banks participate intensively in the management of SMEs.

The Japanese main banking system (Hoshi, 1995) can be seen as an alternative bank-based system. Japanese banks are severely constrained in their ownership of corporate stock, and they own only about 5 per cent of the shares outstanding of any corporation. Large companies in Japan are members of *Keiretsu*[6], the industrial groups in which all elements have very strong mutual ties. *Keiretsu*[7] as an industrial group constitutes a loose association of enterprises headed by a trade company, in whose centre a 'Main bank' operates. These banks are closely involved with industrial enterprises. There is present competition across these groups, whilst within a group member-firms co-operate, more or less closely. The concentration is so high that nine of the leading trade companies control

[5] For more information on the German banking system, see for instance: Stein, 1993; Francke and Hudson, 1984; Edwards and Fischer, 1993

[6] Previously "*zaibatsu*". After 1882 most of the state property was sold to the private sector at extremely good prices. The sales were made especially to members of *Zaibatsu*, prominent Japanese families. Later on, the elements of *Zaibatsu* became large conglomerates, or holdings owning other firms. A *Zaibatsu* family had firms in many branches of economy, because it was not limited. "To some extent this *Zaibatsu* control is like a semi-national government". (Zhang, 1995, p. 130). On *Keiretsu*, see: Gilson and Roe, 1993

[7] Etymologically the explanation is the following. "*Kakari*" means duty, person in charge; "*Kakawari*" means relation, connection, while "*Retsu*" means row, rank, file, column, line. (*Cf.* A. N. Nelson, 1994)

about 1,500 industrial enterprises. The main bank has great power in the management of group members. Japanese enterprises prefer a much more unified and interdependent mode of organisation.

The main bank's share in the ownership of the industrial enterprise cannot exceed 10 per cent in line with the provision of anti-monopoly law. There exists a pattern across ownership among a group of members. The other members, usually, are in possession of 10-30 per cent of the equity of an enterprise, from the same group.[8] Generally speaking, the shareholders' role is one of the main relative positive features of the Japanese financial system. There is a single 'main' bank which has the incentive to exercise the critical monitoring function and because it also has an ownership stake, it does so in a way which reflects both the interests of debt holders and equity holders.

However, the changes in the way the Japanese economy was financed are noteworthy. Until the mid-1970s about 70 per cent of the capital needed for the financing of Japanese corporations was drawn from external sources, mainly from banks. In the mid-1980s the situation changed drastically - internal sources rose up to 70 per cent (Economist, 1986, p. 7). The tendency of strengthening external sources of capital, particularly bonds and equity shares, was actively pursued in the late 1980s.[9] Generally speaking these changes had no significant influence on the overall Japanese economic achievements at the time.

The Anglo-American market based model is set in a strong finance function, and is the preference for internalising risk in the absence of close industry-bank connections. The control is based on financial procedures and a reporting system that tends to treat each unit as a separate profit centre. Many corporations develop market-like relationships between their component parts. Given the dispersion of shares, the individual shareholder is not able to exert any major influence, so it seems that the most important *a posterior* control is based on take-over.[10] With the debt/equity ratio in this system being relatively low, banks are unable to exert any major influence on the managerial structure. If the performance of an enterprise is not satisfactory, the price of shares on the market will decline as a result, and shareholders will be increasingly inclined to sell them. In this situation, the interested investor will be in a position to put his/her hands on the controlling block of shares; so he/she will be in a position to acquire the enterprise and dismiss the current management.

In this model, traditionally, the asset side of banks' balance sheets shows a combination of a small amount of cash and deposits at the central bank, some highly liquid assets such as governmental securities, and a high proportion of non-marketable loans and advances, mostly of indefinite maturity. Their liabilities are overwhelmingly deposits, a fair proportion payable on sight. Also, the proportion of equity is quite small. The situation slightly changed in the 1990s, with the extensive use of different combined active asset-liability management instruments and techniques.

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[8] Regarding main concepts of the Japanese Economic system, see: Ito, 1991; HNK Overseas Broadcasting Department, 1995; Abegglan and Stalk, Jr., 1995; Ballon and Tomita, 1992

[9] In 1990 the debt/equity ratio of the listed corporations was of the order of 1.07, whereas the debt/total assets ratio amounted to 0.3, which was less than in the 1960s and 1970s when this averaged between the 0.4-0.5 range (*Economist*, 1990, p. 104)

[10] See: Harvard Business Review, 1991; Journal of Economic Perspectives, 1988, pp. 3-82

The necessary capital for financing a company comes mostly from internal sources, such as, for example, retained profits and depreciation. External sources of capital include investors and creditors. The investors are buyers of various financial instruments issued by the corporation, and they buy diverse financial instruments expecting a profit. Currently in this model, outside sources of institutional investors predominate and the banks are only one group of players amongst several. The banking system is highly centralised and bank lending tends to be short-term and has not entailed the establishment of close industry-bank relationships. The financial system has imposed constraints on industrial management of high short-term returns on capital, without offering any support through a monitoring function. In this model banking was, to a large extent, until the 1980s a comfortable, profitable and oligopolistic industry, with relatively little freedom (due to over-regulation), but enjoying stable long-term profits. This was a consequence of over-regulation and a wide-spread scheme for deposit protection (insurance). Currently, the banking industry in the Anglo-American model represents an industry of high concentration, while most of the large banks have been organised along the line of holding companies. The main business within these banks includes deposit transactions and extending credits to the firms and households.

It is important to notice the real sector - bank relationship is less dependant on capital volume than on the manner in which it is obtained. Banks are the most conservative investors after depositors. They focus on short-term crediting and have little interest in risk-sharing, or following in corporate control. So, banks are strictly interested in - interest rates. In this framework it is obvious that minimising the risk of bankruptcy cannot maximise the returns of shareholders. Finally, it is obvious why this system is market-based. The stock-market is the critical factor for overseeing company results and, through this, management results. Financial markets, especially the stock-market, provide the concept of external corporate control. In this model the system relies 'on wide dissemination of pubic information and the importance of firm reputation - as opposed to relying on control mechanisms associated with the debt instrument itself' (Udell and Wachtel, 1995, p. 41).

However, the recent (1980s) changes in the regulatory policy treatment of the financial sector brought these two theoretically different systems closer. Under the auspices of deregulation new financial institutions (non-bank financial intermediaries) entered the banking sector (bank-market), increasing competition, reducing the price of banking (interest rate), but as a by-product increasing systemic (systematic) risk. Along with the deregulation went a great number of bank failures (Sheng, 1996, pp. 71-86). The direct link has not been established, but considering the market strategies of banks, the conclusion can be drawn that the management has been exposed to great pressure to be competitive which often led to adventures business strategy and policy. Undoubtedly, deregulation was, by a number of financial agents, comprehended as the end of regulation. But, they forgot that in the well-established market formal rules are often not necessary, since the market introduced effective operating practices and code of conduct. However, the legal rules can stop or slacken the development of new products and self-advancement of the system itself (Sevic, 1999b).

On the other hand, banks started to be involved in capital market operations. Explicit or implicit limits on the banks' participation in the capital (long-term) market has been gradually falling, and as a consequence the volume of trade increased, and banks started to be more seriously involved in financial engineering. The special boom has been noticed

within the trade in derivatives, especially exotic ones.[11] They started to combine two or more classic financial instruments creating new ones, or even 'banking' derivatives, amongst themselves. All these started to change the balance sheet positions of banks. Previously, classical banks were interesting for the regulators because of their asset side of a balance sheet, i.e. they were a major producer of lending services and they pursued this function even in incomplete or failed market situations (Bernanke, 1983). Today, the borrower has a much wider choice: she/he can address him/herself to a financial intermediary (which as a rule is not necessary a bank) or can raise money in the financial markets. Often, even if the debt is towards the bank, debt can be transformed into securities and resold in the financial market. This practice is quite common in the US.

This process of '*securitisation*'[12] required further a redefinition of classic financial instruments that were not tradable. Now, non-tradable financial instruments (usually different kinds of loans) can enter the market, allowing the bank to change its liquidity policy. Classic banks pursued only so-called asset-side management, while at present they practice both asset and liability management. However, innovation seriously affects the powers of supervisory authorities, because accountancy procedures are not as transparent.[13] The emergence of securitisation initiated also the wider *off-balance sheet* activities of banks, which are now even harder to monitor. On the other side, the financial markets had a boom in the volume of trade and - volatility. The complex financial risk started to be more influenced by a large share of systemic risk. Also, earlier the systemic risk in the banking and financial (especially long-term) markets were formally separated due to legal restrictions. But, with the liberalisation of entry in the banking sector, and involvement of banks in security creation, it is quite difficult to distinguish systemic risks in different markets. It seems that the financial system will have a '*consolidated systemic risk*', that will be more and more nationally (cross-industry) defined. At the moment it appears, the question is whether there is a difference between a bank-based and market-based financial system, and if there is - where is it?

In our opinion, particular cultural settings, a broader social framework, etc. will always affect the institutional design. Efficiently, unification of rules for the trade in financial services will cause convergence towards a unique international solution. However, it should be kept in mind that '*ethos*' as a social category can lead to (economically) irrational choices. At present all the countries in the World strengthen the financial (long-term) market, but special differences stay, as previously. Nevertheless, banking (and investment management) as an industry changes the shape... It might be that, perhaps, we have adopted the wrong perspective... Namely, the change in the industry structure is an institutional endogenous change, but such a change always finally needs a formal cover expressed in law. The final decision is always in the hands of the supreme regulator.

In this paper we have observed the typology of the financial system, with attention devoted to the concept of corporate control.[14] The corporate control question appeared naturally to be the main benchmark for various financial systems because the financial system

[11] On derivative activity of financial intermediaries (from a central banker's point of view), see: Federal Reserve Bank of Atlanta, 1993
[12] On this issue, see for instance: P. W. Freeney, 1995
[13] See, for instance: Study Group Report, 1994
[14] For extensive research on this issue, see: Prowse, 1995

has its own flows, but here it serves the real sector. Depending upon how this relationship is defined, the financial structure, as well as the regulatory framework, is built in addition to business policy and the practice of financial institutions. At a glance the only difference is in which institutions are prevalent within the system: banks or markets, but this is not the only difference. Depending on this difference institutions policies, their market behaviour, as well as their liaisons with public institutions in this sector (Central bank, Stock Exchange Commission, Banking Supervisory Authorities, etc.) will be determined. This is, finally, the core difference, that gives to every particular financial system specific, nationally 'coloured' characteristics.[15]

3. Conclusion

Financial system statics is usually considered as an issue that had been addressed (successfully) many years ago. The wave of deregulation in the 1980s re-actualised the problem of the financial system (structure) design. The large number of bank failures around the world in those years implied that something was wrong with the framework which all believed had been efficient. A wide cross-country action for the advancement of financial systems and the search for solutions to the number of detected inefficiencies within the system began in the 1980s and continued during the 1990s. These problems have initiated the re-examination of the very foundations of the financial system and its structure.

In this paper, we have presented the main features of the bank-based and market-based financial system in an impartial manner. Every particular financial system is a result of certain historical developments and serves the understanding of a national economy, not an imaginary country from textbooks. Efficient institutions represent the best social response to instability and insecurity. With the establishment of social institutions human behaviour is much more predictable, and society has balanced development. A social cost has to be paid, but it is sustainable if the institutions perform their functions properly.

The state is the supreme social institution. If the state lays on the firm democratic foundations, it would represent the will of the vast majority of citizens and, generally not pursue actions that are not supported by the people. In doing so, the state develops a structure for other domains of social life. The financial system, as a sub-system of the economic system, is one of them. In supporting the creation of the system the state provides the (formal) regulation and enforces both legal (formal) regulations and informal rules (*autonomous law,* or conditionally *self-regulation*) emerged from positive practice, if the latter is socially sustainable and efficient, supporting main points of the formal rules.

Within this framework, it is clear that the financial system reflects all the main features of the economic settings from which it emerges. We (economists) believe that markets are efficient by themselves, either competitive or contestable. If they are not, there is always a regulatory hand of the government to deal with 'market failures', i.e. to handle natural monopolies, provide public goods, prevent external diseconomies, and remedy existing information asymmetries (Sevic, 1996c). We do not consider banking (or unified financial

[15] For an exhaustive presentation of the financial system see our paper: Sevic, 1995a

sector) as a natural monopoly[16], but banking is a highly regulated industry. The government takes the responsibility for the system's proper functioning.

However, the financial system always follows very closely the economy that it serves. The market-based financial system is associated with the consumer-driven economy of the American (Anglo-American) type. This type of economy bases decisions on the needs of consumers, there is no real long-term planning, often things are performed on a stop and start basis. The least participation of government in economic life, the better. As a result, there are often crises and recessions. The bank-based financial system is, in contrast, associated with the German type social economy or the Japanese administratively guided economy (see: Sevic, 1999a). These countries practice industrial policy measures, support long-term planning, and there is a quite developed social safety net. This is, of course, reflected in the financial system, which is more stable, less subject to crises, and with relatively balanced development.

Meanwhile, the financial crisis of the late 1980s was not avoided even in these well-performing economies. The globalisation of the world financial services initiated involvement of German and Japanese banks more and more in the security business. At the moment, the capital market is not predominant in Japan or Germany, but it is fast-growing in terms of both: volume of traded instruments, and total turnover. It could be expected that it will play a more important role in the near future. However, it is quite unlikely that these two '*big*' economies will move towards an entirely market-based financial system. This type of system is more suitable for fundamental liberalist governments, rather than governments that support the firm implementation of industrial policy. If they opt to transform their financial system, this can create large liquidity and structural problems. Also, in these countries monetary policy instruments are more off-market based, so it requires big changes in the monetary policy implementation process. There are many concessions that the government must make in favour of 'raw' market forces (see: Sevic and Sevic, 1998). It contradicts the historical and social traditions of these countries. Therefore, the financial systems can organisationally converge towards the unique solution, but there always will be a choice, in the final instance: market-based or bank-based financial system.

The question of system redesign has always been acute when some changes are foreseen. Namely, if the European Union is moving towards a federal internal organisation, with the unique monetary system and central bank, it will be necessary to define the unique financial system, which is one of the main prerogatives of federal relations in the economic sphere. The 'Eurocrats' will face the problem that the present structure is quite costly to preserve, so the new institutional arrangement is to be found. At that point the marginal cost of regulatory change and redesign will match the marginal benefit, i.e. the point when the institutional design can fully justify itself.

[16] See: Dowd, 1993

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REDIZAJNIRANJE FINANSIJSKOG SISTEMA - NEDOUMICA IZBORA INSITUCIJA I IZGRADNJE NJIHOVOG POTENCIJALA

Željko Šević

U radu se analizira opšte prihvaćena klasifikacija finansijskog sistema. Finansijski sistemi se klasifikuju u ovom radu kao orjentisani na tržište i i orjentisani ka bankama. Takođe se ukazuje na mnoge podgrupe i razlike među njima. Mada ove razlike spoljnim posmatračima mogu izgledati kao nebitne, u krajnjoj liniji nacionalne razlike mogu znatno uticati na ukupnu stukturu finansijskog sistema i stvoriti hibridno rešenje. Mada i Japanski i Nemački finansijski sistemi mogu biti klasifikovani kao finansijski sistemi zasnovani na bankama, razlike među njima ostaju značajne a uloga banaka u izvesnom smislu različite. U radu se ne analiziraju problemi efikasnosti finajsijskog sistema, već se pažnja usmerava na glavne koncepte organizacije i njegove osnovne karakteristike.