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Dead Man Walking: Opponents of Wal-Mart's Effort to Acquire an ILC Disinter the Separation of Banking and Commerce

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Industrial Loan Corporations (ILCs), although they can offer FDIC-insured accounts, are not defined as banks for purposes of the Bank Holding Company Act, and thus can be acquired by companies not solely engaged in financial activities. Wal-Mart's application to acquire an ILC, filed with the FDIC, has raised the question of whether the policy of separating banking and commerce has any continuing viability after the adoption of the Gramm-Leach-Bliley Act in 1999. Beyond this is the more difficult issue of whether banks should continue to receive protection against competition from outside the financial services industry.

An Industrial Loan Corporation (ILC) is an unusual state chartered financial institution—eligible for federal deposit insurance, but not defined as a bank for purposes of the Bank Holding Company Act (BHCA), the federal law that prohibits affiliations between banks and enterprises that are not engaged solely in financial activities. Wal-Mart, as a retailer, is not permitted to acquire a "bank" under the act, but argues that there is no statutory bar to its acquiring an ILC.

The Federal Deposit Insurance Corporation (FDIC), which must approve Wal-Mart's application, is receiving a good deal of advice that allowing Wal-Mart to acquire an ILC will violate the principle that banks should be separated from commercial activities. Those who take this position argue that an ILC is in all substantial respects a bank and thus should be prohibited from affiliating with a nonfinancial firm such as Wal-Mart. This idea is being urged upon the agency by banks and banking associations, as well as by members of Congress and various government agencies, including the Board of Governors of the Federal Reserve System.

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In this controversy, the FDIC has received little support for approving the Wal-Mart application. Wal-Mart is regarded as an aggressive competitor—which endears it to its customers—and the hallowed principle of separating banking and commerce sounds so, well, hallowed. But the FDIC should approve the application. Although many still cite the separation of banking and commerce as some kind of eternal verity, it was in effect abandoned when Congress adopted the Gramm-Leach-Bliley Act of 1999 (GLB Act). As long as the FDIC believes that it can effectively regulate the ILC, it has little reason to reject the application because the acquisition would allegedly violate the separation principle.

The Gramm-Leach-Bliley Act Eliminated the Policy Basis for Separating Banking and Commerce

The economic policies of the United States do not impose any general prohibition on affiliations between different kinds of financial or commercial enterprises, as long as there is no reason to believe that affiliation will cause harm to the economy or to the health, well-being, or safety of the public.

Thus, companies that control securities firms or insurance companies can also control retailers or manufacturers, and vice versa. Conglomerate mergers and acquisitions may not always make sense financially or as business propositions, but they are not illegal as long as they do not threaten competition. Until the adoption of the GLB Act, the banking industry was an exception to this general rule. Under the BHCA, banks could not be affiliated with any organization that was not engaged either in banking itself or in activities "closely related to banking." The GLB Act did not entirely eliminate this prohibition, but it so broadened the range of affiliations permissible for banks that it eviscerated any policy reason for denying Wal-Mart's application solely on the basis of the principle that banking should be separated from commerce.

Because U.S. economic policies do not recognize restrictions on affiliation unless harm can be shown, proponents of the separation principle for banks have always justified separating banks from commercial firms by citing three different potential dangers associated with affiliation:

- A bank with a commercial affiliate will lend preferentially to its affiliate—either at a concessional interest rate or on terms that would not be offered at arms' length—whether willingly or under duress from its commercial parent;

- A bank with a commercial affiliate will not lend to competitors of its commercial affiliate, thus distorting competition; and

- If a bank's commercial affiliate encounters financial difficulty, the bank's resources will be marshaled to bail it out, using insured deposits for this purpose and jeopardizing the health of the deposit insurance funds and its own safety and soundness.

The first two grounds suggest that the separation principle is based on the notion that the suppliers of credit—at least credit supported by federal deposit insurance—should be separated from the users of credit. The third ground suggests that separation is necessary to protect the safety and soundness of the bank and hence the financial condition of the deposit insurance fund. All three issues were brought clearly to the attention of Congress by Paul Volcker in testimony to a subcommittee of the House Banking Committee in 1997: "We should want decisions on the allocation of credit . . . to reflect unbiased financial judgments, free of taint of serving the interests of a commercial affiliate. . . . How likely would it be, for instance, that a bank affiliated with a powerful retail chain will eagerly lend to a local or regional competitor? . . . What about the temptations to lend to or otherwise support a weak commercial affiliate?"[1] Many others made the same points in similar testimony, in both the House of Representatives and Senate.

It is not my purpose here to assess the validity of these arguments, even though I believe they are entirely fallacious. Banking regulations prohibit *all* these abusive uses of a bank, and impose severe *personal* penalties (in extreme cases, fines of up to $1 million per day) on bank managers and directors if they misuse the bank's assets for the benefit of an affiliated company. Accordingly, the likelihood that a bank's management would open itself to these penalties in order to help an affiliate attain greater profitability or avoid default seems vanishingly small.

But it is not really necessary to dispute the likelihood that any of these dangers will come to pass. In adopting the GLB Act, Congress in effect—despite Mr. Volcker's warnings—determined that none of these dangers or abuses is a sound basis for prohibiting affiliation between banks and other kinds of enterprises that are major users of credit. As noted above, the GLB Act broadened the range of activities with which banks could be associated, permitting affiliations with securities firms and insurance companies and any other firm engaged solely in financial activities. This, however, was not a minor change; when considered in light of the policy reasons for separating banking and commerce, there is no significant difference between a bank's affiliating with a firm engaged solely in financial activities or with a purely "commercial" firm such as Wal-Mart.

This can easily be seen by considering how the policy reasons underlying the separation principle would apply to an affiliation between a bank and, say, a securities firm. Assuming its management were willing to violate banking laws and regulations, could a bank lend preferentially to its securities affiliate? Of course. And could a bank refuse to lend to competitors of its affiliate? Again, certainly. Indeed, securities firms need and use more bank credit than most commercial firms because they use bank loans to carry their inventories of securities.

So if a securities firm controls or is under common control with a bank, that affiliation could affect the bank's lending policies, just as it might if the bank were controlled by, say, Wal-Mart. Again, it is not necessary for purposes of this essay to dispute the likelihood that this will happen, since Congress—by permitting the affiliation—

must have concluded that the likelihood is not great enough to warrant a prohibition on affiliations between securities firms and banks. But if Congress thought banks should be permitted to affiliate with securities firms—large users of credit—what is left of the policy basis for separating the suppliers of credit from the users of credit? The answer is: not much, and certainly not enough to justify the FDIC in turning down the Wal-Mart application solely on this basis.

And finally, if the securities firm that controls or is under common control with a bank got into financial difficulties, could its affiliated bank be importuned to bail it out? Of course. And would the same thing be true in the case of the retailer? Again, yes. So is there any difference—from the perspective of the harms or abuses that the separation of banking and commerce is intended to prevent—between a bank affiliating with a securities firm and the same bank affiliating with a retailer like Wal-Mart? It seems obvious that the answer is no.

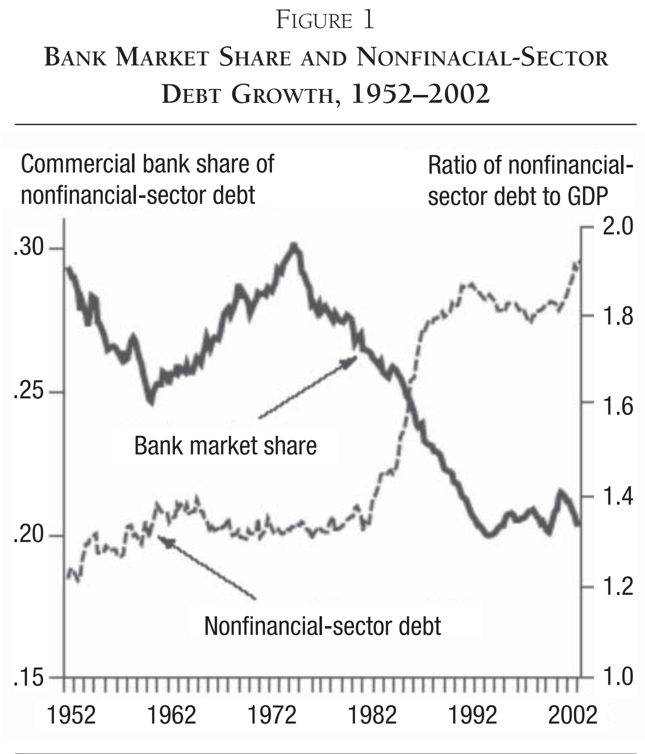
If this is true, the rationale—the policy foundation—underlying the separation of banking and commerce has been completely undermined. If every abuse or potential abuse that is supposed to provide the basis for the separation principle could occur if banks are affiliated with securities firms—which Congress permitted in the GLB Act—what basis could there be for prohibiting affiliations with retailers? Or for that matter with automobile manufacturers, oil companies, or software developers? The answer, it seems, is that there is no remaining rational basis for the distinction; it is completely arbitrary.

Thus, by opening the door to affiliations between the suppliers of credit—i.e., banks—and the users of credit—i.e., securities firms, insurance companies, and other firms engaged in financial activities—the GLB Act did far more than simply widen the circle of activities with which banks could be affiliated under federal law. In effect, it was a statement by Congress that there was no longer any basis for believing that affiliations between the suppliers of credit and the users of credit represent a danger to either or to the economy generally.

Indeed, when finally reached in 1999, this was an entirely rational conclusion; the economy has changed considerably since the predecessor of the idea of separating banking and commerce was formally written into law with the adoption of the Glass-Steagall Act in 1933. At that time, and until the late 1970s, banks faced very little competition as suppliers of credit. Banking relationships were vital to companies and individuals, and the competition among banks was gentlemanly. By reason of

Figure 1

Bank Market Share and Nonfinacial-Sector Debt Growth, 1952–2002



Source: *FDIC Banking Review*16, no.2 (2004): 46.

their centrality to the financial system, banks had real market power. All that changed, however, with the advent of new communication and data processing technology in the 1980s, which permitted the financial data of borrowers to be quickly transmitted and assessed in the public securities market. This eroded the principal value-added of banks' intermediary role—their special knowledge about the financial condition of borrowers; and in the case of the very strongest and largest corporate borrowers, banks' advantage virtually disappeared. With easy and inexpensive access to borrowers' financial information, securities firms, insurance companies, pension funds, and other financial institutions were able to compete effectively with banks as providers of credit. The elimination of interest rate controls on deposits, and the repeal of restrictions on interstate banking and branching, also placed banks in direct competition with one another for both liabilities (deposits) and assets (loans to borrowers). Figure 1 shows how dramatic this change actually was. In the mid-1970s, commercial banks were providing almost 30 percent of all nonfinancial sector debt in the United States, but by the late 1990s this share had fallen to 20 percent—and this despite a dramatic rise in total contracted private sector debt. Clearly, banks were losing customers to other financial intermediaries.

By 1999, the year that the GLB Act was enacted, it was no longer credible to argue that banks had any significant market power. Corporate treasurers and chief financial officers were deluged with visits from bankers looking for lending business; individual consumers were deluged with mail from banks offering personal loans, credit cards, and mortgage financing. It became clear that a bank's refusal to lend to competitors of its securities affiliate would simply result in the loss of that business to a competing bank. Oddly, even in this environment, Paul Volcker and others argued that a bank affiliated with a retailer might hesitate to make a loan to a local competitor of its affiliate. If the bank were so foolish as to pass up this lending opportunity, however, many of its competitors were waiting in line to make the loan. Moreover, new laws and regulations adopted in the early 1990s, particularly the Federal Deposit Insurance Corporation Improvement Act of 1992 (FDICIA), imposed significant new personal penalties on bank directors and officers who approved transactions with affiliates that disadvantaged or overreached the bank. It must have seemed highly unlikely to lawmakers considering the GLB Act in 1999 that any of the potential abuses would actually occur, or would occur so frequently that they should stand in the way of reform.

Why the Separation Principle Has Staying Power

All of this raises the question of why, if there is no longer any danger associated with affiliations between banks and commercial firms, there has been such an outpouring of concern about Wal-Mart's possible acquisition of an ILC. The reason is fear—fear on the part of small banks that they will face new competition from Wal-Mart, that the company will eventually expand its activities into the deposit-taking and lending that is the bread and butter business of local community banks. Even large banks may be concerned that the approval of Wal-Mart's application will start a trend in which many companies will acquire "captive" ILCs, giving them access to the payment system that they once could obtain only by purchasing this service from an independent bank.

The Federal Reserve has also been an important factor in promoting the separation principle. It administers the BHCA, the primary function of which is to regulate and restrict the affiliations of banks. Under the act, bank-holding companies—companies that control banks—must obtain the Fed's approval before making acquisitions or establishing new businesses. Since most banks in the United States—and all large banks—are subsidiaries of holding companies, the BHCA has given the Fed a broader reach into the banking industry than it would have solely as a bank regulator. Without the BHCA, the Fed would be the primary federal regulator only for state chartered banks that are members of the Federal Reserve System—a class that is dwindling as many of the larger banks convert from state to national charters issued by the Comptroller of the Currency.

Accordingly, simply as a matter of turf protection, the Fed has consistently taken the view that the separation of banks from commercial businesses is necessary to protect against the risks described by Paul Volcker—a former Fed chairman—in his 1997 testimony. Although the GLB Act broadened the permissible affiliations of banks—allowing for the first time affiliations between banks and substantial users of bank credit such as securities firms—it was acceptable to the Fed because it preserved the agency's power to control the acquisitions and activities of bank holding companies.

Thus, it is possible to draw the following conclusions about the separation of banking and commerce after the GLB Act. The policy arguments underlying the separation principle have no remaining vitality. However, the idea that banking and commerce should be separated continues to have life as a way of protecting banks against competition from outside the financial services industry and for preserving the Federal Reserve's regulatory authority over the banking industry.

Important Remaining Issues

That, however, is not the end of the matter. Recently, the Government Accountability Office (GAO), at the request of Congressman Jim Leach (R-Iowa), assessed whether the acquisition of an ILC by a commercial firm or retailer such as Wal-Mart would create risks for the economy or the deposit insurance fund maintained by the FDIC.[2] The GAO's report takes note of the policy of separating banking and commerce, but makes no effort to explain why the control of an ILC by Wal-Mart or some other commercial firm would be any more troublesome than control of a bank by a securities firm. Instead, the GAO noted only that it was unable to "identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce."[3] Of course, this is looking at the issue through the wrong end

of the telescope. U.S. economic policy, as noted above, does not impose restrictions on affiliation unless some potential harm can be identified. It is not, under this policy, the duty of the government to find reasons for permitting affiliation, but rather to impose restrictions only where they are necessary. Since Congress, in adopting the GLB Act, appears to have decided that there is no identifiable harm in allowing banks to affiliate with heavy users of credit such as securities firms, the separation principle does not provide a basis for the FDIC's rejection of the Wal-Mart application. For these reasons, the GAO's discussion of the separation of banking and commerce does not add materially to the debate on whether a commercial firm such as Wal-Mart should be permitted to acquire an ILC.

However, there is a second and more interesting element in the GAO report. In assessing the relative regulatory authorities of the FDIC (the regulator of insured ILCs) and the Federal Reserve (the regulator of the holding companies of banks), the GAO found that the Fed's authority as a consolidated regulator—that is, a regulator with authority to oversee both the holding company and the subsidiary bank—was greater than the authority of the FDIC to regulate the ILC alone. The FDIC has no explicit authority to inquire into the activities of the company that controls either a bank or an ILC, but contends—and the GAO acknowledged—that it has extensive authority to protect the ILC against overreaching by a parent company, or against risks that the parent company might create for the insured subsidiary. The GAO did not conclude that the greater authority of the Fed was actually necessary, but only that "we are concerned that insured institutions providing similar risks to the [Bank Insurance] Fund are not being overseen by bank supervisors that possess similar powers."[4]

Here we come to a truly interesting question of public policy. It seems clear that the policy of separating banking and commerce—to the extent that it is deemed to prevent a Wal-Mart from acquiring a bank-like institution such as an ILC—is protecting banks against competition and inhibiting the kind of innovation and efficiencies that ultimately benefit the public. Against the obvious benefits that would come from allowing Wal-Mart and others to compete with banks, it is necessary to weigh the value of allowing a regulator such as the Fed to oversee and regulate the holding company of an insured depository institution. Does consolidated regulation provide so much more protection to depository institutions than regulation by the FDIC alone that it outweighs the traditional U.S. policy favoring competition?

The GAO did not balance these two objectives—or even recognize that they are in conflict—but that is the most fundamental question raised by Wal-Mart's application.

Notes

1. Subcommittee on Financial Institutions and Consumer Credit of the House Banking Committee, *Statement of Paul A. Volcker*, 105th Congress, 1st Session, February 25, 1997.

2. Government Accountability Office, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO report GAO-05-621, September 2005, available at http://www.gao.gov/new.items/d05621.pdf.

3. Ibid., 80.

4. Ibid., 79.