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August 2017

Wal-Mart and Banking

Case Study

Memorandum

FROM: Staff Director, Senate Banking Committee

TO: Staff Assistant

RE: Wal-Mart Industrial Loan Company

Date: February 2010

Part I: Introduction

An Industrial Loan Company (ILC) or Industrial Bank is a state-charted depository institution insured by the FDIC. In most respects, an ILC functions exactly like a commercial bank, except that it cannot provide checking accounts payable on demand if it has total assets greater than $100 million.[1] There are, however, two critical distinctions between an ILC and a standard bank. First, an ILC may be owned by a commercial firm, constituting an important exception to the longstanding U.S. policy of separating banking and commerce. Second, the parent company of an ILC is not subject to comprehensive regulation and supervision by the Federal Reserve Board, as are normal bank holding companies under the Bank Holding Company Act ("BHCA")[2] or the Gramm-Leach-Bliley Act (GLBA).[3] This loophole in the financial regulatory system came to the fore when Wal-Mart attempted to charter an ILC and enter the retail banking market in 2005.

The Obama administration has called for an end to the ILC loophole. Under the administration's proposed reforms, ILCs could no longer be owned by or affiliated with commercial firms, and ILC parent companies would be subject to Federal Reserve Board supervision and regulation. The administration argued as follows:

> Congress added the ILC exception to the BHC Act in 1987. At that time, ILCs were small, special-purpose banks that primarily engaged in the business of

1 Bank Holding Company Act, 12 U.S.C. § 1841(c)(2)(H)
2 Bank Holding Company Act, 12 U.S.C. § 1841
3 Gramm-Leach-Bliley Act, 113 Stat. 1338

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> making small loans to industrial workers and had limited deposit-taking powers. Today, however, ILCs are FDIC-insured depository institutions that have authority to offer a full range of commercial banking services. Although ILCs closely resemble commercial banks, their holding companies can avoid the restrictions of the BHC Act – including consolidated supervision and regulation by the Federal Reserve – by complying with a BHC exception. Formation of an ILC has been a common way for commercial companies and financial firms (including large investment banks) to get access to the federal bank safety net but avoid the robust governmental supervision and activity restrictions of the BHC Act. *Under our plan, holding companies of ILCs would become BHCs.*[4]

On December 11, 2009, the House of Representatives approved the Wall Street Reform and Consumer Protection Act of 2009. This bill would effectively abolish the ILC loophole and achieve the Obama administration's objectives. Although the House bill continues to exempt ILCs from BHCA regulation, it would become much more difficult to qualify as an ILC. In addition to the existing restrictions, the House bill adds two new requirements. First, an ILC must "predominantly [provide] financial products and services to current and former members of the military and their families".[5] Second, an ILC must be "controlled by a savings and loan holding company."[6] These requirements essentially end the ILC loophole because as savings and loan holding companies, ILCs would be subject to strict activity restrictions and comprehensive supervision by the Comptroller of the Currency.[7] Thus, ILCs could no longer be owned by non-financial companies.

The issue of financial reform now rests squarely in the Senate. Please study the following materials relating to the ILC exemption and Wal-Mart's involvement in this issue. Review the arguments for and against the reform proposed in the House bill, and then provide a well-reasoned recommendation as to how the committee members should vote on the ILC issue.

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4 U.S. Treasury Department, *Financial Regulatory Reform: A New Foundation*, June 2009, 35. Emphasis added.

5 H.R. 4173, 11th Cong. § 1301(a)(4)(D) (as engrossed by House, Dec.11,2009) (hereafter cited as *House Bill*).

6 *Id.*

7 Carnell Macey and Miller, *The Law of Banking and Financial Institutions, 4th ed.* (Aspen Publishers) 38; *House Bill* § 1204.

Part II: Background and Analysis

History

Industrial Banks have existed since 1910, but they gained their current importance when Congress passed the Competitive Equality Banking Act of 1987 ("CEBA").[8] CEBA closed the loophole that exempted "nonbank banks"[9] from the Bank Holding Company Act, but left in place the ILC exception. Only states that already granted ILC charters prior to the passage of CEBA could continue doing so. Of the seven states thus authorized, Utah has adopted the most favorable laws for ILCs. Utah has thus become the jurisdiction of choice for financial and non-financial firms seeking to avoid more robust BHCA regulation. Although numerous large corporations like Target, Goldman Sachs, and General Electric have made use of ILCs for years, they garnered little attention. The issue only came to the fore in 2005 when Wal-Mart, always a lightning rod for controversy, attempted to charter a Utah ILC. Professor Arthur Wilmarth describes the events:

> In July 2005, Wal-Mart Stores, Inc. applied to the Federal Deposit Insurance Corporation (FDIC) to obtain federal deposit insurance for a proposed industrial bank, which would be named "Wal-Mart Bank" and would be chartered under Utah law. . . . [T]he primary activity of the proposed Wal-Mart Bank would be to act as a sponsor for the processing and settlement of credit card payments, debit card payments, and check payments made by customers at Wal-Mart stores. In addition, Wal-Mart Bank would offer certificates of deposit to charitable organizations and to individuals through deposit brokers.
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> Wal-Mart declared that Wal-Mart Bank would not open any branches or deal directly with the public. Nevertheless, if Wal-Mart's application had been approved, the world's largest retailer would have owned an FDIC-insured depository institution with powers equal to those of commercial banks (except for the ability to offer checking accounts payable on demand). In

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8 Competitive Equality Banking Act of 1987, 101 Stat. 552, https://www.gpo.gov/fdsys/pkg/STATUTE-101/pdf/STATUTE-101-Pg552.pdf.

9 *Id.* Before CEBA a bank was defined as an institution that accepted deposits and made loans, "nonbank banks" avoided regulation by performing only one or the other function.

> view of Wal-Mart's past efforts to acquire full-service depository institutions, many commentators predicted that Wal-Mart's proposed industrial bank would eventually seek to open branches in Wal-Mart stores and to exercise the full range of financial services authorized by its Utah charter.
>
> Wal-Mart's application provoked intense opposition from a broad coalition consisting of community bankers, officials of the Federal Reserve Board (FRB), labor unions, retail stores, community activists, and members of Congress. Wal-Mart's opponents advanced numerous arguments, including the claim that a major commercial firm should not be permitted to acquire an FDIC-insured institution. In July 2006, . . . the FDIC responded to this widespread opposition by placing a six-month moratorium on Wal-Mart's application and all other pending applications to obtain federal deposit insurance for industrial banks or industrial loan companies (ILCs). Shortly thereafter, the FDIC invited the public to comment on twelve policy issues related to acquisitions of ILCs by commercial (i.e., non-financial) companies.
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> In December 2006, more than a hundred members of Congress asked the FDIC to extend its moratorium so that Congress could consider proposed legislation that would prohibit commercial firms from acquiring ILCs. On January 31, 2007, the FDIC extended its moratorium for an additional year with respect to pending applications by Wal-Mart, Home Depot and other commercial firms to acquire control of ILCs. At the same time, the FDIC lifted its moratorium with regard to pending applications by financial companies or individuals to acquire ILCs.[10]

By the time the moratorium expired in January of 2008, Wal-Mart and others, including Home Depot, had voluntarily withdrawn their FDIC applications, and the beginnings of the subprime mortgage crisis had chilled appetites for new banks. It is possible that the FDIC will

[10] Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 Conn. L. Rev. 1539, 1541-2 (2007).

delay processing of any new ILC application by a commercial company in order to give Congress more time to act on the pending reform legislation.[11]

Wal-Mart Value Proposition

Wal-Mart has long been embraced by rural and lower-income populations, but sharply criticized by labor and environmental groups, consumer advocates, and the numerous businesses it has put or threatens to put out of business. The debate over Wal-Mart's attempt to charter an ILC has become a battleground for this wider controversy.

Empirical research on Wal-Mart's impact on communities is just as sharply divided. A Global Insight study commissioned by Wal-Mart concluded that working families save an average of $2,500 per year by having a Wal-Mart in their community.[12] But others dispute this study, claiming that it was "based on shopping at all stores in a market after the presence of Wal-Mart drove prices down at competing retailers."[13] A University of Missouri study found that the opening of a new Wal-Mart store has a positive impact on net retail employment in the surrounding area. This impact is most pronounced in the short term, although it is sustained over a 5-year horizon.[14] However, Iowa State University researchers found that Wal-Mart stores cause total retail trade to decline nearly 50% in a given area over a 10-year period.[15] A study by Pennsylvania State University found that counties with a Wal-Mart on average had higher poverty rates than counties with no Wal-Mart.[16]

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11 Peter J. Wallison, "The FDIC on the Spot," American Enterprise Institute: Financial Services Outlook, January 2008, 1.

12 Wal-Mart Stores, Inc., "American Families Now Save $2,500 a Year, Thanks to Wal-Mart," September 12, 2007, Wal-Mart Stores, Inc. Web Site, corporate.walmart.com/_news_/news-archive/2007/09/12/american-families-now-save-2500-a-year-thanks-to-wal-mart, accessed April 2009 [perma.cc/CB9Z-6CC3].

13 David Kiley, "Wal-Mart's Bad Week," April 1, 2008, *BusinessWeek Magazine*, https://www.bloomberg.com/news/articles/2008-03-31/walmarts-bad-week (subscription required), accessed April 2009.

14 Emek Basker, "Job Creation or Destruction? Labor Market Effects of Wal-Mart Expansion," Department of Economics, University of Missouri, March 11, 2005, http://ideas.repec.org/p/wpa/wuwpla/0303002.html [perma.cc/GTX6-7ME5], accessed April 2009.

15 Kenneth Stone, "Impact of the Wal-Mart Phenomenon on Rural Communities," Iowa State University, Published in Proceedings *Increasing Understanding of Public Problems and Policies – 1997*, http://www.econ.iastate.edu/faculty/stone/10yrstudy.pdf [perma.cc/F8A5-DK2B] accessed April 2009.

16 Stephan J. Goetz and Hema Swaminathan, "Wal-Mart and County-Wide Poverty", Department of Agricultural Economics and Rural Sociology, The Pennsylvania State University, October 18, 2004, aese.psu.edu/research/centers/cecd/research/wal-mart-and-county-wide-poverty [perma.cc/V8QY-PKXL], accessed April 2009.

Wal-Mart maintains that the Utah ILC would almost exclusively act as the agent for its own transactions in the Visa and MasterCard networks or as its own "merchant acquirer."[17] But nothing in the ILC charter would prevent Wal-Mart from expanding its banking services and becoming a serious competitor to retail banks, and Wal-Mart can make a compelling argument for the value it might bring to low-income consumers through retail banking.

According to "The Unbanked and Underbanked Factsheet" on Wal-Mart's website, 28 million people in the United States are unbanked, representing nearly 15 million households or 10% of the population, and 45 million people are "underbanked," representing 24 million households or 15% of the population. Unbanked consumers are those who lack access to mainstream financial services. Underbanked consumers may have access to financial services, but don't use them regularly. Together, 73 million people representing nearly 40 million households and 25% of the U.S. population are financially underserved. Much of this population already makes up Wal-Mart's core customer base,[18] so it is logical for Wal-Mart to pursue a strategy of providing banking services to these existing customers. Offering branded financial services is seen as a key way to strengthen customer loyalty and leveraging it into expanded buyer relationships.[19]

Wal-Mart already provides as many financial services as are permitted without a bank charter, including check-cashing, wire transfers, and stored-value cards. As described by Mary McDowell:

> Rather than using a checking account as a foundation product for its customer base, Wal-Mart's foundation offering is its MoneyCard, a partnership with GE Money and Green Dot that allows customers to load paychecks or cash onto a prepaid Visa card, which they may use at any outlet that accepts Visa. According to the Wal-Mart Money Management fact sheet, 'Wal-Mart's MoneyCard serves as a convenient, safe alternative to carrying cash, having a checking account or charging a credit card.' The fee structure

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17 David Breitkopf, "Wal-Mart's Financial Vision: In Payments: Spotlight on an ILCs Role," *American Banker*, October 5, 2005.

18 Mary McDowell. Wal-Mart Financial Services: Using History and Context to Inform How Wal-Mart Can Successfully Navigate the Evolving World of "Big Box" Banking 5 (2009) (unpublished final paper, Harvard Law School Consumer Finance Course)

19 Jacqueline S. Gold, "Stocking the Shelves with Financial Services," *American Banker*, December 1, 2000.

> for the MoneyCard…compares favorably to average prices on foundation products offered by financial institutions nationwide (particularly following a February 2009 price "roll-back"), *provided that* MoneyCard holders take advantage of fee-minimizing opportunities, such as reloading their cards by direct deposit or within a Wal-Mart store…Compared to other options in the non-traditional financial services market, Wal-Mart also offers pricing advantages…Wal-Mart's fee charged per transaction is significantly lower than the industry average for wire transfers and check cashing. And while consumer advocates voice their concern that "prepaid debit cards are an expensive way to bank" due to high fee structures, most agree that by targeting low-income consumers with financial products, Wal-Mart has the potential to reduce the presence of check cashers and payday lenders in low-income neighborhoods, institutions known for predatory practices and astronomical APR's.[20]

But Wal-Mart currently offers no savings product, and the idea of linking banking so closely with consumer spending may not in the best interest of consumers.[21]

Despite the value Wal-Mart could potentially bring to low-income consumers, opposition has been intense, especially from smaller local banks. Opponents of Wal-Mart's ILC application may be justifiably worried about main street banks being put out of business. When asked about Wal-Mart's assurances that it will keep out of retail banking, William T. Owens, an executive at the Farmers Savings Bank and Trust in Vinton, Iowa, said, "It is difficult to believe that when you look at how Wal-Mart has taken over other lines of business—everything from eyewear to groceries."[22]

Wal-Mart has attempted to pacify the banking industry by pointing to its extensive program of leasing space to community banks to open branches within Wal-Mart stores. More than 300 banks have arrangements with Wal-Mart already, adding up to more than 1,100 branches in Wal-Mart stores throughout the United States.[23] According to Jane Thompson, president

[20] McDowell, "Wal-Mart Financial Services," p. 17.

[21] *Id.* p. 17-18

[22] Rob Garver, "Wal-Mart's Financial Vision: In Retail: Focus on Unbanked, Partnerships, Home Grown ATMs," *American Banker*, October 5, 2005.

[23] *Id.*

of Wal-Mart Financial Services, that number will grow to at least 1,400 in-store branches within three years, each one owned and operated by an independent bank.[24] These banks typically have 15 year leases, which Wal-Mart has no right to terminate, so Wal-Mart is currently committed to these branches for the foreseeable future.[25]

However, banks may feel less reassured by Wal-Mart's actions internationally. In November 2006, the Mexican Finance Ministry granted approval for Wal-Mart's Mexican subsidiary to establish a full-service bank throughout Mexico called Banco Wal-Mart de Mexico Adelante.[26] Wal-Mart plans to open retail branches in hundreds of stores that will offer a full range of financial services, including deposits and loans.[27] These actions in Mexico lend credence to U.S. critics who fear that Wal-Mart will expand as far into retail banking in the United States as it is legally allowed to do. In fact, in 2003, Wal-Mart's then CEO H. Lee Scott, Jr. publicly stated that "financial services is [an area] we would like to be in. [. . .] There's probably a place for us in mortgages."[28]

But even if Wal-Mart does succeed in entering retail banking, some argue that small banks' fears are overstated given that community banks already face competition from large national banks.[29] Small banks have survived and thrived due to their ability to offer personalized service, an advantage that they would also have over Wal-Mart. However, Wal-Mart is unlike any other firm, and it is impossible to predict what its presence in the retail banking sector would mean.

Policy Arguments against ILCs

This debate over Wal-Mart's entry into banking takes place within the wider arena of the longstanding policy of separating banking and commerce in the United States. Since the first bank charter in U.S. history was granted for the Bank of North America in 1787, banks have generally been prohibited from affiliating with commercial firms, either as parents, subsidiaries, or affiliates.[30] Although loopholes have always existed, Congress has

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[24] *Id.*
[25] *Id.*
[26] Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1549.
[27] *Id.*
[28] Abigail Goldman, "The Wal-Mart Effect: Proud to Be at the Top," L.A. Times, Nov. 23, 2003, A32, available at LEXIS, News Library, LAT File.
[29] Garver, "Wal-Mart's Financial Vision."
[30] Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1554-55.

consistently enacted legislation to close them whenever businesses began using them widely.[31] The Senate Committee Report on CEBA stated that "the principle of separating banking and commerce [is] a policy that has long been the keystone of our banking system. . . . The separation of banking from commerce helps ensure that banks allocate credit impartially, and without conflicts of interest."[32] The one significant loophole left after CEBA is the ability of commercial firms to own ILCs. Senator Jake Garn of Utah, co-sponsor of the ILC exemption, has said "it was never my intent, as the author of this particular section, that any of these industrial banks be involved in retail operations. . . . I would be the most vociferous opponent of that because that was not my intent at the time CEBA was passed."[33] Nevertheless, the ILC exemption exists and has come to be used widely by financial and non-financial firms.

The separation of banking and commerce is founded on four principal policy concerns involving potential risks to the financial system.[34] First, allowing commercial firms to affiliate with FDIC-insured institutions is likely to spread the federal safety net to the commercial sector. Second, banks owned by commercial firms will face conflicts of interest that pressure them to make preferential and possibly unsound loans to their parents or affiliates. Third, any problems arising in a bank's commercial parent could lead to a loss of confidence in the bank itself, facilitating bank runs and panics. Fourth, even if federal regulators could supervise commercial parents of ILCs, they are unsuited to conduct this type of regulation, and it would cause a burdensome government intrusion into the commercial sector.

Extension of Federal Safety Net to Commercial Firms

By allowing commercial firms to own FDIC-insured depository institutions, the commercial parent becomes an implicit beneficiary of the federal safety net.[35] Although the Federal Reserve and the FDIC are funded by member banks, recent scholarship indicates that the

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31 *Id.* at 1554-71.

32 *Id.* at 1570.

33 *Id.* at 1572.

34 *Id.* at 1588.

35 "The federal "safety net" for financial institutions consists of (i) federal deposit insurance, (ii) protection for uninsured depositors and other uninsured creditors of TBTF institutions, (iii) discount window advances provided by the FRB as "lender of last resort" (LOLR), and (iv) the FRB's guarantee of interbank payments made on Fedwire." See Wilmarth note 284 at 1588.

safety net they create may still act as a significant net subsidy to member institutions.[36] A 2005 GAO report confirms these findings, explaining that the federal safety net "provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds," and by "shift[ing] part of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers."[37] Indeed, during the Savings and Loan crisis of the 1980s and early 1990s, the deposit insurance fund was exhausted and Congress authorized $132 billion in taxpayer money to pay for the cost of bank failures.[38]

The federal safety net subsidy becomes even more pronounced when a bank achieves Too Big to Fail ("TBTF") status. As Wilmarth explains:

> Whether or not small banks enjoy a subsidy, many analysts believe that the safety net provides significant subsidies to the largest banks that are viewed as TBTF by the financial markets. Those analysts have found that (i) TBTF banks—generally those with assets over $100 billion—pay interest rates on deposits that are significantly lower than the rates paid by non-bank companies of comparable size on short-term, uninsured debt, (ii) TBTF banks operate with significantly higher leverage (i.e., lower capital-to-asset ratios) than uninsured financial intermediaries such as commercial and consumer finance companies and life insurers, and (iii) TBTF banks achieve higher credit ratings and pay lower interest rates on their bonds as they grow in size to achieve TBTF status. Indeed, the TBTF subsidy has been an important motivating factor behind the rapid consolidation that has taken place in the banking industry in the United States and other developed nations over the past two decades.
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> The existence of a subsidy for TBTF institutions is further indicated by the fact that no major U.S. bank has ever surrendered its bank charter and chosen to

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36 Joe Peek & James A. Wilcox, The Fall and Rise of Banking Safety Net Subsidies, in Too Big to Fail: Policies and Practices in Government Bailouts 170, 187-89 (Benton E. Gup ed., 2004)

37 U.S. Gen. Accountability Office, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority 15, 65-67 (2005), available at www.gao.gov/assets/120/114373.pdf [perma.cc/N45A-U6ZV]; Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1589.

38 Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1589.

> operate as a nonbank. In contrast, large nonbanking companies have consistently sought to gain control of FDIC-insured depository institutions. . . . Each of the four largest U.S. securities firms—Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers—owns a Utah-chartered ILC. Charles Schwab, the largest discount securities broker, and MetLife, the largest life insurer, purchased banks shortly after the enactment of GLBA and became financial holding companies. Currently, thirty-three insurance companies own some type of bank, and fifteen commercial firms own ILCs.[39]

If Wal-Mart were allowed to charter an ILC, it would likely become a beneficiary of the federal safety net subsidy. Given its gigantic customer base, Wal-Mart would almost certainly succeed in attracting a huge volume of low-cost deposits and achieving TBTF status. This would lead to two potential problems. First, Wal-Mart would have a significant funding advantage over its competitors, creating market distortions and reducing competition. Second, if Wal-Mart ever faced insolvency, the federal government would face great pressure to provide it with a federal bailout, resulting in potentially huge costs to taxpayers.[40]

Conflicts of Interest and Preferential Lending

When ILCs are subsidiaries or affiliates of commercial firms, they can face significant pressure to make preferential loans that can lead to unsoundness. As Wilmarth explains:

> Acquisitions of ILCs by commercial firms create conflicts of interest that pose significant risks to the deposit insurance fund and increase the likelihood of a systemic economic crisis. . . . ILCs enjoy a significant funding advantage over non-banking firms, due to their ability to attract FDIC-insured deposits at subsidized, below-market rates. Commercial owners of ILCs have powerful financial incentives to transfer this funding advantage by causing their ILCs to pay generous dividends and to make preferential loans to the parent companies and their commercial subsidiaries. The desire to draw on funds from a bank affiliate intensifies when the commercial parent or a commercial

[39] Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1589-90.

[40] *Id.* at 1593.

> affiliate encounters financial problems. For example, after Caldwell and Company and American Continental Company (the parent of Lincoln Savings) lost access to other sources of funds, they extracted large amounts of funds from their depository institution affiliates. Similarly, Bank of United States failed after making large loans to support its securities and real estate affiliates.
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> Commercial firms could also cause their ILCs to support their operations in other ways. For example, a parent company could cause its ILC to purchase doubtful customer receivables or other questionable assets, or it could insist that the ILC encourage its depositors and other customers to purchase the parent's securities. . . .
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> In addition, commercial firms may induce their ILCs to make preferential loans to suppliers of the parent company in order to gain concessions for the parent company.[41]

To prevent exactly these types of unsound preferential loans, Congress has adopted certain restrictions on transactions between banks and their affiliates. These restrictions are codified as sections 23A and 23B of the Federal Reserve Act. For a wide range of bank-affiliate transactions, section 23B requires terms and conditions that are at least as favorable to the bank as (i) the prevailing terms for comparable transactions involving nonaffiliated companies or (ii) in the absence of comparable transactions, terms that would be offered in good faith to nonaffiliated companies.[42] Section 23A specifies that covered transactions between a bank and any one affiliate must be limited to 10% of the bank's capital and surplus, and covered transactions between a bank and all of its affiliates cannot exceed 20% of the bank's capital and surplus. Covered transactions are defined in the statute to include extensions of credit or purchases of securities or assets by the bank. Further, all extensions of credit to an affiliate must be secured by qualifying collateral.[43]

41 Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1594-95.
42 Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102(a), 101 Stat.552 (1987).
43 Banking Act of 1933, Pub. L. No. 73-66, § 13, 48 Stat.162 (1933).

While these rules should theoretically prevent any abusive transactions between ILCs and their affiliates, twin dangers exist: the rules will be difficult to enforce, and they are likely to be ignored, especially in times of crisis. As Wilmarth states:

> [T]hese firewalls have often been disregarded under circumstances of financial stress when the financial viability of a controlling shareholder or affiliate is threatened. . . . [A] high percentage of thrift failures during the 1980s involved violations of rules governing affiliate transactions and insider lending. Similarly, a GAO study found that unlawful insider lending and abusive affiliate transactions occurred at a significant proportion of 175 banks that failed during 1990-1991. For example, United States National Bank of San Diego failed in 1973 after making massive loans to its controlling shareholder and his affiliates in violation of legal lending limits. Hamilton National Bank also failed in 1976 after its parent holding company violated section 23A by forcing the bank to purchase large amounts of low-quality mortgages from the bank's mortgage banking affiliate. During the 1987 stock market crash, Continental Illinois violated legal lending limits in order to prevent its options trading subsidiary from failing.
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> Two large FDIC-insured ILCs have failed since 1999, resulting in losses to the deposit insurance fund of more than $100 million. In each case, the corporate parent and the ILC operated in a unitary fashion that did not maintain any meaningful corporate separation between them, and the parent and the ILC also engaged in transactions that violated sections 23A and 23B.[44]

Further, "the restrictions in sections 23A and 23B are complicated and difficult to enforce," and "managerial evasions" of these sections are often subtle and difficult to detect.[45] Given that bank regulators are already overburdened and have failed to detect massive abuses such as Enron or the present financial crisis, it may be unrealistic to expect them to detect

[44] Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1596-97.

[45] Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, U. Ill. L. Rev. 215, 456, 457 (2002).

more subtle abuses among the myriad transactions that could take place between a huge commercial firm like Wal-Mart and its subsidiary ILC.[46]

Contagious Loss of Confidence

Banks are already highly susceptible to losses of public confidence, and affiliation with commercial firms exacerbates the problem. Poor performance or crises in the parent firm can lead to a loss of confidence in a perfectly sound subsidiary bank. The financial subsidiaries of U.S. automobile manufacturers illustrate this point. When Chrysler Corporation experienced serious operational and financial difficulties in 1991-1992, the credit ratings of subsidiary Chrysler Financial Corp. were reduced to junk bond levels.[47] When Ford Motor Company and General Motors Corporation experienced similar problems more recently, the credit ratings of their captive finance subsidiaries, Ford Motor Credit Company and General Motors Acceptance Corporation, likewise fell from investment-grade levels to junk bond status.[48]

Just as GM once appeared invincible, Wal-Mart may appear unstoppable today. However, no firm is immune from risk, and Wal-Mart is exposed to risks from increasing dependence on China, intense opposition and negative publicity, and market saturation.[49] If Wal-Mart experienced serious financial difficulties, the crisis would certainly spread to its subsidiary ILC. If that ILC contained the insured deposits of millions of customers, it would lead to large losses to the FDIC insurance fund, if not total liquidation. It is likely that Wal-Mart itself would receive a large taxpayer bailout to maintain confidence in the subsidiary bank.

Federal Regulation of Commercial Activities

Unlike the substantial regulatory authority of the Federal Reserve over Bank Holding Companies and their subsidiaries, the FDIC lacks significant authority to regulate commercial parents or affiliates of ILCs. Wilmarth describes the limitations on the FDIC’s powers:

> . . . [I]t is sufficient to note three significant limitations on the FDIC's authority to supervise an ILC's parent holding company and the nonbank subsidiaries

46 Wilmarth, “Wal-Mart and the Separation of Banking and Commerce,” 1597.
47 *Id.* 1607-08.
48 *Id.* at 1608.
49 *Id.* at 1609-10.

of that company. First, the FDIC has only a limited power to examine the parent company or one of its nonbank subsidiaries. The FDIC may examine an “affiliate” of the ILC—a category that includes the parent company and each of its nonbank subsidiaries—but only to the extent “necessary to disclose fully (i) the relationship between [the ILC] and any such affiliate; and (ii) the effect of such relationship on the [ILC].” Thus, the FDIC's examination authority over the parent company or a nonbank subsidiary is limited to identifying the “relationship” which that company has with the ILC and determining whether that “relationship” has the potential to harm the ILC. The FDIC does not have authority to examine the parent holding company and its nonbank subsidiaries for the purpose of evaluating the overall safety and soundness of the holding company.

Second, the FDIC cannot impose capital requirements on the parent company of an ILC or on any of its non-bank subsidiaries. The FDIC has authority to establish capital requirements only with respect to state nonmember banks, including ILCs. The FDIC could insist, as a condition of approving an application for deposit insurance, that an ILC's parent company must enter into a capital maintenance agreement with the FDIC. Under such an agreement, the FDIC could require the parent company to maintain the ILC's capital at specified levels in order to preserve the ILC's status as an FDIC-insured bank. However, the FDIC cannot dictate the capital structure of the parent company or its nonbank subsidiaries.

Third, the FDIC has only limited authority to bring administrative enforcement proceedings (including actions for cease-and-desist orders or civil money penalties) against an ILC's parent company or its nonbank subsidiaries. For purposes of its enforcement authority, the FDIC can treat the ILC's parent company as an “institution-affiliated party” (IAP), because that term includes a controlling shareholder (other than a bank holding company) of a state nonmember bank. However, the FDIC cannot treat a nonbank subsidiary of the parent company as an IAP unless it “participates in the conduct of the [ILC's] affairs.” In addition, the FDIC may not bring an enforcement action

> against an IAP unless that person (i) has engaged or is about to engage in an unsafe or unsound practice in conducting the business of the ILC, or (ii) has violated or is about to violate a law, rule or written agreement or condition imposed by the FDIC. Thus, the FDIC's enforcement authority does not extend to non-bank subsidiaries of the parent company that are not IAPs. Moreover, the FDIC cannot bring action against an IAP based on alleged unsafe or unsound practices that are not directly related to the ILC's business.[50]

However, giving the FDIC more meaningful authority to regulate an ILC's parent and affiliates would create its own problems:

> . . . [T]he creation of a federal consolidated regulator for commercial parent companies of ILCs would have at least four negative effects. First, the FDIC does not have any substantial experience or specialized expertise in evaluating the safety and soundness of commercial conglomerates. Naming the FDIC as consolidated supervisor for commercial parent companies of ILCs would greatly increase the FDIC's supervisory burden and would compel the FDIC to hire new personnel with expertise in many different sectors of the U.S. economy.
>
> Second, designating the FDIC as consolidated regulator would have the undesirable effect of implying that the federal government is monitoring and assuring the overall solvency and stability of each commercial firm that owns an ILC. That implication might lead market participants to expect that the federal safety net would be extended to commercial parent companies of ILCs.
>
> Third, federal consolidated supervision of commercial owners of ILCs would greatly expand the scope of federal regulation within the commercial sector of our economy. From the 1950s through the 1990s, governmental authorities in Japan and South Korea played an extensive role in monitoring and

50 Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1613-15.

directing the relationships between main banks and their commercial clients. Government regulators frequently pressured banks to provide credit to designated high-growth industries or to provide support for troubled commercial firms. Giving the FDIC a similarly intrusive role in monitoring dealings between banks and their commercial affiliates could significantly interfere with the market-driven dynamics of the U.S. economy.

Federal law currently requires the FDIC to oversee every transaction that results in a transfer of control of an ILC or its parent company. . . . [T]he Change in Bank Control Act (CBCA) requires the FDIC to review, and to decide whether to disapprove, any proposed change in control of a state nonmember bank. The CBCA therefore provides a significant impediment to any hostile takeover of a parent company of an ILC. . . . Hence, acquisitions of ILCs by commercial firms are likely to impair the effectiveness of market discipline over managers of the parent companies.

Fourth, major commercial firms that acquire ILCs are likely to use political influence to obtain subsidies or forbearance from regulators. Big commercial companies that own ILCs are likely to be not only TBTF but also "too big to discipline adequately" (TBTDA). Major banks have proven to be TBTDA in the past. For example, during the banking crisis of 1984-1992, Bank of America and Citicorp, the two largest U.S. banks, each came perilously close to failure. However, federal regulators did not take public enforcement action against either bank or insist upon a replacement of its managers. Instead, regulators quietly entered into a nonpublic "memorandum of understanding," the weakest type of enforcement action, with each bank. Regulators evidently were unwilling to take strict enforcement measures against either bank because they feared that public disclosure of the bank's problems might 'trigger a generalized crisis of [public] confidence' in the banking system.[51]

[51] Wilmarth, "Wal-Mart and the Separation of Banking and Commerce," 1617-19.

In sum, the affiliation of banks and commercial firms will cause regulatory problems regardless of the regulatory structure.

Policy Arguments in Favor of ILCs

There are also strong policy reasons that support allowing commercial firms to charter ILCs. The Gramm-Leach-Bliley Act in 1999 ("GLBA") allowed financial companies, such as securities firms and insurance companies, to own FDIC-insured banks. This seriously undermines many of the arguments against mixing banking with commercial firms, including preferential lending, contagious loss of confidence, and extending the safety net.[52]

The risk that a commercial firm like Wal-Mart will seek preferential loans from its ILC is no greater than the risks that a securities or insurance firm will do so. As noted, sections 23A and 23B of the Federal Reserve Act place limits on how much a bank may loan to its affiliates and requires that all such transactions be conducted at arm's length. Bank officers who approve violations of these sections or any other banking laws and regulations face a personal fine of up to $1 million per day, in addition to possible criminal liability.[53]

The adoption of GLBA indicates that Congress has moved toward the view that it is better to regulate transactions between a bank and its affiliates than to try to regulate all the activities of those affiliates.[54] Although there is evidence that sections 23A and 23B are hard to enforce and have sometimes been ignored in times of crisis, the passage of GLBA suggests that Congress believes they are sufficient to regulate transactions between banks and nonbank financial companies.[55] And if these regulations ensure that banks make only arm's length loans to their affiliates, as Congress seems to believe, then affiliates will not be able to enjoy the federal safety net subsidy by getting access to cheap credit.[56]

All of this means that the main justification for barring commercial firms, but not financial firms, from owning or affiliating with banks must be that commercial firms are somehow riskier than financial firms. However, this does not appear to be true. Securities firms, for

52 Peter J. Wallison, "The FDIC on the Spot," 3.
53 *Id.*
54 Lawrence J. White, "Wal-Mart and Banks: Should the Twain Meet? A Principles-Based Approach to the Issues of the Separation of Banking and Commerce," *Contemporary Economic Policy* 27 (2009): 440.
55 Peter J. Wallison, "The FDIC on the Spot," 3.
56 *Id.* at 4.

example, are some of the riskiest enterprises in our economy.[57] The productive assets of a securities firm consist almost entirely of sales personnel who maintain good client relationships. These relationships are highly dependent on the firm's reputation, and one serious scandal can quickly lead to the firm's implosion.[58] Insurance firms are similarly subject to rapid and devastating collapse, as demonstrated by AIG's huge losses in the current financial crisis.

On the other hand, commercial firms, while clearly subject to risk, own their productive assets or control them by contract. In the event of loss in market confidence, commercial firms are much less susceptible to rapid implosion.[59] Wal-Mart, for instance, has fared quite well during the current recession. And during the extensive period when commercial firms were allowed to own a single thrift institution, few problems ensued from this mix of banking and commerce.[60]

These considerations are especially true given that financial firms are allowed to charter ILCs and thus escape comprehensive regulation as a Financial Holding Company. Financial companies, especially investment banks, have taken advantage of this exception. Of the twelve Utah-chartered ILCs with the largest assets before the 2008 financial crisis, nine are owned by financial companies.[61] Four of the top five are investment banks: Merrill Lynch, Morgan Stanley, UBS, and Goldman Sachs.[62] Lehman Brothers owned the ILC with the ninth largest assets.[63] Starting with Merrill Lynch, investment banks converted brokerage clients' uninvested balances into FDIC-insured deposits, which they then used as a cheap way to become more leveraged without being regulated as Financial Holding Companies.[64] While the ILCs themselves fared surprisingly well during the financial crisis, every investment bank-parent company went bankrupt or received a government bailout, and it is possible to argue that the increased leverage made possible by their ILCs played a significant role in their

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57 *Id.*
58 *Id.*
59 Peter J. Wallison, "The FDIC on the Spot," 4.
60 Lawrence J. White, "Wal-Mart and Banks: Should the Twain Meet?," 445.
61 Cambridge Winter Center for Financial Institutions Policy, *Industrial Loan Companies and Shadow Banking*, 2009, 8.
62 *Id.*
63 *Id.*
64 *Id.* at 7.

vulnerability.[65] As long as non-commercial firms are allowed to use ILCs in such risky ways, any justification for prohibiting commercial firms from owning ILCs is seriously weakened.

Conclusion

In this time of systemic financial crisis, Wal-Mart's application for an ILC has forced us to face an important question. Does the longstanding separation of banking and commerce protect consumers by maintaining the safety and soundness of the banking system, or does it harm consumers by limiting competition and access to financial services? Opportunities for serious financial reform are rare, and the choices made by Congress now will shape financial regulation for decades to come. The ILC exemption, although seemingly small, has created significant distortions in the financial system. The question remains whether these distortions are positive or negative. Please weigh the competing information and policy considerations and provide a thoroughly-supported recommendation as to how the Senate Banking Committee should vote on this issue.

[65] *Id.* at 7.