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The Right Policy for Industrial Loan Companies

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Those who oppose the current law as it applies to industrial loan companies (ILCs) argue that allowing nonfinancial companies to acquire ILCs violates the policy of separating banking and commerce. In this testimony, I will review the underlying policy arguments in favor of the separation of banking and commerce and show that the separation idea no longer has any rational policy basis. Instead, the policy now serves principally to protect the banking industry against competition and to deprive consumers of the benefits that would flow from allowing nonfinancial firms to gain access to the functions that are currently available only to insured banks.

For these reasons, Congress should leave the current law on ILCs unchanged. Holding open this opportunity for nonfinancial firms to combine with insured depository institutions will be an important and useful experiment. Congress can watch how this structure works, see the benefits it will provide for consumers and working families, and determine whether any of the supposed dangers actually arise. In the end, I am confident Congress will find that the great hue and cry stirred up about ILCs was wholly unnecessary.

In thinking about the separation of banking and commerce, we should recognize that our economic and regulatory structure accepts very few restrictions on combinations

between companies in different industries. Many of the restrictions that existed in the past—such as a prohibition on railroads owning other modes of transport, or banks affiliating with securities firms—have been abandoned because they were shown to have unduly restricted innovation and competition. In antitrust law, conglomerate mergers—which do not involve either horizontal or vertical integration—generally present no policy problems, and analysts recognize that allowing such combinations generally enhances competition, spurs innovation, and reduces prices for consumers.

Thus, to overcome the presumption that combinations between companies in different industries should be permissible—in other words, to demonstrate a need to prevent nonfinancial firms from acquiring or chartering ILCs—the proponents of restrictive legislation must show some harm to the economy, to consumers, or to some other policy objective.

As I will discuss below, Congress has already decided in the Gramm-Leach-Bliley Act (GLBA) that no harm can result from combinations between banks and other financial organizations, no matter what their size. As I hope to make clear, there is no real difference between financial affiliates and commercial affiliates; they both raise the same issues. Under these circumstances, the only harm that can come from a change in the law is harm to consumers and working families.

The arguments in favor of separating banking and commerce

Those who advocate the continued separation of banking and commerce—and thus restrictions on nonfinancial companies owning ILCs—cite the following potential harms:

- Permitting combination between insured banks and commercial firms could create undue concentration of assets or financial resources;
- If a commercial firm were to control a bank, it might force the bank to lend preferentially to the commercial parent or the parent's affiliates, or forbid the bank from lending to the parent's competitors;
- If a commercial parent were to control a bank, it might misuse the bank as a financing source when the commercial firm needs credit but cannot find it elsewhere because of its weak financial condition. This would, in effect, extend the bank safety net to its commercial parent.
- Commercial activities are riskier than banking activities, and thus the commercial parents of insured banks cannot be sources of strength for their bank subsidiaries.

I will consider these arguments in turn below.

Undue concentration of assets or resources. As noted above, combinations among firms from different industries pose no antitrust problems and are routinely permitted by the Federal Trade Commission and the Department of Justice. In addition, the GLBA imposes no restrictions on the size of the combinations that are permissible under that act. Thus, it would be possible for the largest bank holding company to acquire the largest securities firm and insurance company. This suggests that Congress did not view the threat of large combinations of financial assets as particularly significant.

If large combinations of financial assets were not deemed to be a threat, why

should combinations between commercial firms and financial institutions be prohibited? First, it is necessary to point out that there is no federal law or regulation that prohibits a commercial company from acquiring an insurance or securities firm, no matter what the size. So the relevant question is whether there is something about a commercial company acquiring an insured institution such as a bank or an ILC. Analysis will show that this poses no greater threat than other combinations.

As noted above, there are three possibilities—banks or ILCs will lend preferentially to their commercial parent or the parent's affiliates; they will not lend to competitors of their commercial affiliates; and their commercial affiliates will use the bank as a source of financing when the financial condition of the commercial affiliate is so weak that it is unable to borrow from any other source. This last possibility raises the question of whether the bank safety net might be extended in this manner to a commercial firm.

None of these possibilities has any basis in reality. This is especially true for ILCs, which are small insured institutions, but for the following reasons it is also true for the largest banks:

Preferential lending. If preferential lending is to occur, it must violate federal banking law and regulations. Sections 23A and 23B of the Federal Reserve Act limit loans to all affiliates as a group to 20 percent of a bank's capital, and requires that this lending take place at arms length and be secured by collateral of up to130 percent of the loan. In addition, Section 1818 of the Federal Deposit Insurance Act imposes criminal liability and a possible *personal* fine of up to $1 million per day on any bank official who

approves a violation of banking law or regulations.

Accordingly, it would be irrational for a bank or ILC official to risk a penalty of that kind in order to make a preferential loan to an affiliate.

Indeed, there is good reason to believe that Congress accepts the fact that banking laws and regulations have eliminated the problem of preferential lending. The GLBA permits banks to affiliate with securities firms and insurance companies. Securities firms, in particular, are among the heaviest users of bank credit, which they use to carry their securities trading inventory. If the possibility of preferential lending was not considered significant enough to require special restrictions on lending between banks and affiliated securities firms—other than 23A and 23B—there is no reason to suppose that preferential lending between banks and commercial firms would be more of a problem.

Denial of credit. The GLBA is also relevant for considering whether banks or ILCs that are affiliated with commercial firms might deny credit to competitors of those affiliates. The GLBA makes no special provision for the possibility that banks affiliated with securities firms or insurance companies might refuse to extend credit to the competitors of these affiliates. This is particularly significant because the GLBA was heavily negotiated and was adopted only after the concerns of many interested parties were addressed. There are thousands of securities firms and insurance companies which—directly or through their trade associations—participated in the development of the GLBA, yet the act contains no provision that would address and attempt to prevent the possibility that many of them would have to compete with companies affiliated with banks.

The reason for this is obvious. The are now so many sources of credit in the United States that even if a bank were to refuse to lend to the competitors of its affiliated insurance company or securities firm those competitors would have no trouble getting bank or other financing elsewhere. If Congress did not think denial of credit was a significant danger when it permitted affiliations between banks and securities firms or insurance companies, there is no reason to believe that it would be any more significant if banks or ILCs were affiliated with commercial firms.

Lending to financially troubled affiliates and extending the safety net. What I said above about the laws and regulations applicable to banking is also relevant here. Loans to affiliates must be at arms length, and bank officers who provide credit to a financially weak affiliate are placing themselves and their families at risk for enormous personal fines and criminal charges.

It is likely that it was because of these legal restrictions that Congress was not concerned about this issue when, through the GLBA, it approved the acquisition of banks by securities firms and insurance companies. All financial institutions, including insurance companies and securities firms, can and do encounter financial reverses. Securities firms are particularly fragile—much riskier enterprises than commercial firms—because many of their assets are short term or depend on the continuing loyalty of employees and the goodwill of clients. Yet, in allowing banks to affiliate with securities firms, Congress made no special provisions in the GLBA to prevent bank parents or affiliates from demanding special financial accommodations that might, in effect, spread the bank safety net to cover these organizations.

If Congress did not see the need—beyond Sections 23A and B and the severe penalties in the Federal Deposit Insurance Act—for protecting banks and the safety net against the demands of affiliates or parents such as securities firms, there is no reason to suppose that these demands would be any greater if made by commercial affiliates that own banks or ILCs.

Commercial parents are riskier than banks. This is certainly true, but since the adoption of the GLBA it is not relevant. Securities firms, which can now control banks, are among the riskiest companies in our economy. They are heavily dependent on sales and other personnel who go down the elevator every night. Their customers and employees are also sensitive to the firm's reputation in the market. That's why securities firms such as Kidder Peabody and Drexel Burnham imploded quickly after encountering financial scandals. Commercial firms, in contrast, own their productive assets or control them under enforceable contracts. They are subject to the risk of loss, of course, but not the kinds of implosions that occur in the financial industry.

Once Congress, in the GLBA, allowed securities firms to acquire banks, it in effect conceded that the "source of strength" argument for the continued separation of banking and commerce had no merit.

Accordingly, if we look closely at all the reasons for preserving the policy of separating banking and commerce we find that none of them is significant or remotely persuasive. This is especially true when the effect of the policy is to harm to consumers and working families.

The separation of banking and commerce and the harm to consumers

Frequently we hear the argument that, even if the separation of banking and commerce is not a soundly based policy, what's the harm? Most members of Congress are not regularly approached by constituents who want to acquire banks, so why bother to change the policy? The answer is that as long as this policy keeps companies like retailers, auto manufacturers, and other suppliers of consumer goods out of the banking business it will prevent the full benefits of competition from reaching consumers.

One of the advantages of ILCs is that they allow retailers and others who have substantial credit card charges at their stores to gain access to the payment system—which is permissible only for insured institutions like ILCs and banks—at less cost than if they had to do it through an unaffiliated bank. These lower costs, among other savings, will be passed on to consumers.

In addition, allowing nonfinancial companies to enter into competition with banks will bring more competition, more capital, more innovation and lower costs to the banking industry. This has happened in virtually every case where Congress has deregulated an industry. The influx of new competitors and new capital has been one of the reasons we have such a dynamic economy. The effort to shut down the ILC is basically an effort to prevent this from happening in the banking business. In the end, it will be bad for the banking business—which will be deprived of the benefits of vigorous competition—as well as consumers.

Finally, no one should be under an illusion that if the policy of separating banking and commerce is imposed on ILCs it will still leave ILCs as a viable industry. In fact, it will stop the industry's growth in its tracks. People in Congress may not have noticed, but

the GLBA did not result in securities firms and insurance companies acquiring banks—even though this was permissible. Of the 700 or so financial holding companies that have been formed, only a handful are the result of the acquisition of banks by securities or insurance firms. All the rest are the result of bank holding companies getting into the securities or insurance business.

In other words, the GLBA did not create the two-way street that was advertised. Why not? The reason is that insurance companies and securities firms have been reluctant to acquire banks and thus become subject to the Fed's decision on whether a particular activity they want to enter is "financial in nature."

The perils associated with this are shown by the Fed's inability, over 8 or so years, to declare that real estate brokerage is a financial activity suitable for an FHC. In other words, the GLBA creates a kind of "roach motel"—recalling the old advertisement for a cockroach trap that claimed the roaches went in but never came out. Financial companies such as securities and insurance firms that enter the Fed's jurisdiction by acquiring banks become trapped. Not only do they have to divest the nonfinancial businesses they are already in, but they may be forbidden in the future to enter any other business they believe is necessary for competitive purposes—unless the Fed considers it to be "financial in nature."

This has not been a problem for the bank holding companies. For them the GLBA was liberating; it allowed them to expand into financial areas from which they had previously been excluded. But for securities firms and insurance companies, among others, the separation of finance and commerce—as implemented by the GLBA—creates

a set of unknown future limitations that their managements have not been willing to accept.

The same thing will be true if the separation of banking and commerce is applied to ILCs. Even financial companies will shy away from acquiring or chartering ILCs, because it will mean a billet in another kind of roach motel.

The underlying reasons for the policy.

If there are—as it appears—no valid policy reasons for separating banking and commerce, why does this so-called "principle" still receive support in Congress? The most benign explanation recalls Oliver Wendell Holmes's remark that "[a] good catchword can obscure analysis for fifty years." The idea of separating banking and commerce is a powerful slogan, and it has obscured analysis for even longer than that.

When the policy first made a formal appearance, in a statement to Congress by the Federal Reserve Board in 1938, there might have been some reason for such a rule. At that time, banks were powerful and unique sources of credit in our economy. A robust commercial paper market and lending by finance companies and securities firms were either limited or nonexistent. In addition, banks were geographically confined and could not move from state to state (or in some states from county to county).

For these reasons, banks had real market power in their markets. The denial of credit by a bank was a real threat to the viability of companies and the security of individuals. In addition, bank regulation was not as thoroughgoing as it is today, and bank officers did not face the draconian penalties applied by FDICIA if they violated

restrictions on affiliate lending. Under these circumstances, affiliation with a bank could have been a huge advantage. All that, of course, has now changed. Banks now compete on a nationwide basis, and anyone who collects his or her mail can't miss the fact that banks are aggressively looking for customers. Denial of credit is not a problem.

So one reason that the separation of banking and commerce, as an idea, survives today is that few people in Congress have thought seriously about whether it makes sense any more.

But there are other reasons. Unfortunately, the separation of banking and commerce now serves two interests. The first is the interest of the banking industry in keeping out competition. Companies acquiring ILCs will create new competition for banks. One cannot blame the banking industry for arguing against this new competition—it's an American tradition—but there is no reason for Congress to approve such a policy. It certainly makes stated concerns about consumers and working families seem insincere.

The other party with an interest in the continued separation of banking and commerce is the Federal Reserve Board. The movement of state chartered banks to national charters has meant that the Fed's principal role as a regulator in the banking system is through its regulation of bank holding companies. It's reasonably clear that if the separation of banking and commerce were eliminated and commercial firms could acquire banks, the Fed would no longer be able to maintain its role as regulator of holding companies. This should not be a policy problem; there is no reason why the FDIC or any other federal bank regulator could not—using the powerful laws I've

described—adequately regulate and supervise a bank that is a subsidiary of a commercial firm without any direct control over its parent company.

However, as long as the separation of banking and commerce remains in place, and the Fed—under the GLBA—has the authority to decide what is a financial activity and to regulate bank and financial holding companies, it will retain important power over the banking industry, even though at this point it regulates and supervises very few of the largest banks. So this committee will find the Fed very concerned about relaxing or eliminating the separation of banking and commerce.

What is a financial activity?

Although in this testimony I have treated commercial activities and financial activities as though they are really different, that is not actually true. There is no clear line between commercial activities and financial activities, nor can there be.

The Fed's authority to declare what is a financial activity is actually an impossible task. This is shown by the 8 year old controversy about whether real estate brokerage is a financial activity. Securities brokerage is undoubtedly financial; so is mortgage brokerage. But apparently the status of real estate brokerage is not clear.

What's the distinction? Is it that the thing being brokered, a mortgage or a security, is a financial instrument—a *chose in action* as we called it in law school—and not a tangible thing? If you think that's the distinction, what is a lease? A lease is a way to hold real estate, or a car, or an airplane? Leasing and lease brokerage is clearly a financial activity, but what is transferred though a lease is possession of a tangible thing.

Can real estate agents broker leases? Is a company that leases cars different from a company that buys and resells them? Could a bank or a financial services holding company own a company that leases cars but not one that sells them? What if 60 percent of its revenue or profit is from leasing rather than sales? If this is beginning to sound like counting angels on the head of a pin you can see why the Fed has been given an impossible job.

Congress should end this game by eliminating the reason for drawing these highly artificial distinctions.

Summary

To summarize, then, the separation of banking and commerce has no valid policy basis anymore. In today's world, where credit is readily available to everyone, the separation of banking and commerce simply protects the banking industry against competitive entry by nonbanks and deprives consumers and working families of the lower costs and other benefits they would receive if commercial firms could combine with banks. Accordingly, the elimination of the policy of separating banking and commerce, which would allow nonbanking companies of all kinds to acquire or charter ILCs, is the best kind of pro-consumer legislation. If Congress will leave the law as it is—even as an experiment—it will become clear that separating banking and commerce is not necessary.