"EXAMINING THE REGULATION AND SUPERVISION OF INDUSTRIAL LOAN COMPANIES": HEARING BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE

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Introduction

Thank you for inviting me to participate in this important hearing. My testimony will address three major policy questions related to acquisitions of industrial loan companies (ILCs) by commercial organizations.[1] First, does commercial ownership of ILCs conflict with a general U.S. policy of separating banking and commerce? Second, do commercially-owned ILCs present risks to the U.S. financial system and the broader economy that are greater than the risks posed by financial holding companies? Third, does the FDIC have adequate supervisory powers to control the potential risks created by commercially-owned ILCs, despite the FDIC's lack of consolidated supervisory authority over the commercial parent companies?[2]

The FDIC has imposed a temporary moratorium on acquisitions of ILCs by commercial firms. That moratorium is scheduled to expire on January 31, 2008.[3] The FDIC issued its moratorium after more than a dozen large commercial organizations –

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[1] This testimony is adapted from the following article, which was published earlier this year: Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539-1622 (2007). I have submitted that article for inclusion in the record of this hearing.

[2] The policy questions addressed in my testimony were highlighted by the Federal Deposit Insurance Corporation (FDIC) earlier this year, when it invited Congress to consider whether to adopt legislation that would prohibit further acquisitions of ILCs by commercial firms. The FDIC imposed a moratorium on such acquisitions in July 2006 and extended that moratorium for an additional year on January 31, 2007. *See* Fed. Deposit Ins. Corp., "Moratorium on Certain Industrial Bank Applications and Notices: Limited Extension of Moratorium," 72 Fed. Reg. 5290 (Feb. 5, 2007) [hereinafter FDIC Moratorium Extension Notice], at 5291-93 (discussing policy issues raised by commercially-owned ILCs).

[3] *See id.* at 5290.

including Wal-Mart and Home Depot – filed applications to acquire ILCs.[4] The FDIC held three days of public hearings in April 2006 and heard testimony from nearly seventy witnesses, most of whom opposed acquisitions of ILCs by commercial firms. The FDIC also received more than 13,800 written comments on Wal-Mart's application, with the great majority opposing that application.[5]

On July 28, 2006, the FDIC placed a six-month moratorium on the processing of Wal-Mart's application and other applications by ILCs for deposit insurance.[6] A few weeks later, the FDIC issued a request for public comment on policy issues related to acquisitions of ILCs.[7] As the FDIC noted, the federal Bank Holding Company Act (BHC Act)[8] generally prohibits commercial firms from owning FDIC-insured "banks."[9] However, the BHC Act exempts an ILC from the definition of "bank," and thereby permits a commercial firm to own an ILC, if the ILC satisfies two criteria.[10] First, the ILC must be chartered in a state that, on March 5, 1987, had in effect or under

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[4] On March 16, 2007, Wal-Mart withdrew its application to acquire an FDIC-insured ILC that would be chartered by the State of Utah. Wal-Mart apparently withdrew its application because it concluded that widespread opposition to its application increased the likelihood that Congress would pass legislation to prohibit further acquisitions of ILCs by commercial firms. However, in a subsequent interview, Wal-Mart's president, H. Lee Scott, Jr., indicated that Wal-Mart has not given up its idea of acquiring an ILC. In addition, Home Depot's application to acquire EnerBank, a Utah-chartered ILC, remains pending before the FDIC. *See* Wilmarth, supra note 1, at 1541 n.*, 1595-96 (discussing Wal-Mart's decision to withdraw its application and Home Depot's pending application); Joe Adler, "In Brief: Banking Still on Wal-Mart's Agenda," *American Banker*, Mar. 29, 2007, at 20 (quoting interview on Fox News in which Mr. Scott said that "[w]e are looking at how we can get another bite of that apple," and replied, "Oh, no," when asked whether the possibility of acquiring an ILC was a "dead issue" for Wal-Mart).

[5] Wilmarth, supra note 1, at 1545-46.

[6] Fed. Deposit Ins. Corp., "Moratorium on Certain Industrial Loan Company Applications and Notices," 71 Fed. Reg. 43482 (Aug. 1, 2006) [hereinafter FDIC Moratorium Notice].

[7] Fed. Deposit Ins. Corp., "Industrial Loan Companies and Industrial Banks: Notice and Request for Comment," 71 Fed. Reg. 49456 (2006) [hereinafter FDIC Request for Comment].

[8] 12 U.S.C. §§ 1841-50.

[9] *See* FDIC Request for Comment, supra note 7, at 49458; U.S. General Accountability Office, "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621, Sept. 2005 [hereinafter GAO-ILC Report], at 15, 65-67; Wilmarth, supra note 1, at 1566-70.

[10] 12 U.S.C. § 1841(c)(2)(H). *See* Wilmarth, supra note 1, at 1570-73 (discussing exemption for ILCs).

consideration a law requiring ILCs to obtain deposit insurance.[11] ILCs currently operate in seven states – California, Colorado, Hawaii, Indiana, Minnesota, Nevada and Utah – that authorize the chartering of FDIC-insured ILCs.[12] Second, the ILC must either have assets of less than $100 million or must refrain from accepting demand deposits (i.e., checking accounts payable on demand).[13]

Thus, ILCs with assets of more than $100 million may not offer demand deposits, but they can offer negotiable order of withdrawal (NOW) accounts to individuals and nonprofit organizations.[14] NOW accounts are functionally equivalent to interest-bearing checking accounts.[15] Accordingly, ILCs of all sizes can offer deposit accounts with check-writing features to all of their customers except for-profit businesses.[16] ILCs chartered under Utah law may use the title "bank" in their name and may exercise powers comparable to those of a state-chartered commercial bank, including the acceptance of deposits (except for demand deposits) and the making of consumer and commercial loans.[17]

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[11] *Id.* § 1841(c)(2)(H)(i).

[12] *See* FDIC Moratorium Notice, supra note 6, at 43482; Statement of Douglas A. Jones, Acting General Counsel of the FDIC, on "Industrial Loan Companies: A Review of Charter, Ownership and Supervision Issues," before the House Committee on Financial Services, July 12, 2006, at 2 (available at www.fdic.gov/news/news/speeches/chairman/spjul1107.html).

[13] 12 U.S.C. § 1841(c)(2)(H)(i) (I), (II). An ILC is also exempt from treatment as a "bank" under the BHC Act if it has not undergone a change of control since August 10, 1987, or if it does not engage, either directly, indirectly or through an affiliate, in any activity in which it was not engaged as of March 5, 1987. *Id.* § 1841(c)(2)(H)(i)(III), (ii). According to the FDIC, only twelve ILCs that are currently in operation were insured by the FDIC prior to August 10, 1987. Thus, only a small number of ILCs could potentially rely on these grandfathered authorities. *See* Statement of Douglas A. Jones, supra note 12, at 11-14 (Attach. 1).

[14] 12 U.S.C. § 1832; *see* GAO-ILC Report, supra note 9, at 23-24..

[15] Wilmarth, supra note 1, at 1550.

[16] *See* GAO-ILC Report, supra note 9, at 6 & n.5.

[17] *See id.* at 21-22, 24-25; Fed. Deposit Ins. Corp., Industrial Bank Subsidiaries of Financial Companies: Notice of proposed rulemaking, 72 Fed. Reg. 5217 (2007) [hereinafIter FDIC Proposed Rule on Consolidated Supervision], at 5221 n.32 (stating that "Utah industrial banks have essentially the same powers as Utah commercial banks except that industrial banks have more limited securities powers and less specific investment authority than commercial banks").

In addition, the Federal Deposit Insurance Act (FDI Act)[18] grants to ILCs the same powers and privileges that it provides to other FDIC-insured state banks.[19] For example, an ILC may "export" the interest rates permitted by the state in which it is "located" when the ILC makes loans to borrowers residing in other states.[20] An ILC may also establish interstate branches based on the same terms that apply to other FDIC-insured state banks that are chartered by the ILC's home state.[21] Under current law, for example, a Utah-chartered ILC can establish interstate de novo branches in thirty-four states.[22] In addition, a Utah ILC could operate branches throughout the nation if it is willing to acquire (and merge with) banks in the sixteen states where it cannot open de novo branches.[23]

In sum, under applicable state and federal laws, a commercially-owned ILC can conduct a nationwide banking business as long as it refrains from accepting demand checking accounts and thereby maintains its exemption from treatment as a "bank" under the BHC Act. At the end of 2006, fifty-eight ILCs were in operation, including forty-five institutions chartered by Utah and California and thirteen chartered by Colorado, Hawaii, Indiana, Minnesota and Nevada. Commercial firms owned fifteen of those ILCs.[24]

The FDIC received more than 12,600 written submissions in response to its request for comment on policy issues related to acquisitions of ILCs. Over eighty percent

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[18] 12 U.S.C. §§ 1811-35a.
[19] Under the FDI Act, a state-chartered ILC that is engaged in the business of accepting deposits other than trust funds is considered to be a "State bank." 12 U.S.C. § 1813(a)(2).
[20] *See* 12 U.S.C. § 1831d; GAO-ILC Report, supra note 9, at 21-22.
[21] *See* 12 U.S.C. §§ 1828(d)(4) & 1831u; GAO-ILC Report, supra note 9, at 78-79.
[22] Currently, FDIC-insured banks may establish interstate de novo branches in seventeen states that permit banks from any state to open such branches. In addition, banks headquartered in Utah can establish interstate de novo branches in seventeen additional states that have branching laws that are reciprocal with Utah's branching statute. GAO-ILC Report, supra note 9, at 78.
[23] *See* 12 U.S.C. § 1831u.
[24] FDIC Moratorium Extension Notice, supra note 2, at 5291. California and Colorado have enacted laws barring commercial firms from acquiring ILCs chartered in those states. Wilmarth, supra note 1, at 1547. Consequently, Utah has become the primary focus for commercial firms seeking to acquire ILCs.

of those submissions opposed any further acquisitions of ILCs by commercial firms. In addition, more than a hundred members of Congress sent a letter to the FDIC on December 7, 2006, requesting that the FDIC extend its moratorium so that Congress could act on legislation to prohibit commercial firms from acquiring additional ILCs.[25]

On January 31, 2007, the FDIC extended its moratorium on acquisitions of ILCs by commercial firms for an additional year. The FDIC extended the moratorium because it concluded that acquisitions of ILCs by commercial firms raised special policy issues that warranted consideration by Congress. The FDIC also stated that it had "continuing concerns about commercial ownership of ILCs," because "the current supervisory process and infrastructure may not produce the safeguards that the FDIC believes could be helpful in identifying and avoiding or controlling, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from that kind of company ownership model."[26]

In its moratorium extension notice, the FDIC identified the following major policy questions: (i) whether commercial ownership of ILCs produces a mixing of banking and commerce that is contrary to established U.S. policy, (ii) whether commercial ownership of ILCs creates undue risks for the U.S. financial system and the broader economy, and (iii) whether the FDIC's has adequate supervisory powers to control such risks, despite the FDIC's lack of consolidated supervisory authority over the commercial parent companies of ILCs.[27] Those three questions are addressed in Parts 1, 2 and 3 of the "Policy Analysis" section of my testimony.

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[25] FDIC Moratorium Extension Notice, supra note 2, at 5292-93.
[26] *Id.*
[27] *Id.* at 5292-93.

Part 1 summarizes the history of federal and state legislation regarding the authority of banks to engage in commercial activities and the ability of commercial firms to own banks. Since our Republic's founding, banks have frequently tried to expand their activities into nonfinancial areas, and commercial firms have often attempted to control banks. However, federal and state legislators have generally sought to separate banks from commercial businesses. Indeed, legislators have repeatedly imposed legal restraints on bank powers and have prohibited bank affiliations with commercial firms when it appeared that either (i) the involvement of banks in commerce threatened their safety and soundness, or (ii) commercial firms were acquiring significant numbers of banks. The policy of separating banking and commerce has gained strength during the past half-century. On four occasions since 1956, Congress has adopted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. ILCs represent the only significant exception to the general policy that prohibits acquisitions of FDIC-insured depository institutions by commercial firms.

Part 2 discusses three reasons why further acquisitions of ILCs by commercial firms are likely to create serious risks for our nation's financial system and general economy. First, the ownership of ILCs by large commercial firms will spread federal safety net subsidies to the commercial sector of the economy. Second, as shown by the financial history of the United States and other nations, commercially-owned ILCs face conflicts of interest that encourage them to make loans and investments to benefit their commercial affiliates. In combination, the extension of safety net subsidies to commercial firms and preferential lending by commercially-owned ILCs will (i) threaten the solvency of the deposit insurance system and (ii) create a competitive imbalance between commercial firms that own ILCs and those that do not. Third, problems arising at commercial owners of ILCs are likely to create public concerns about the soundness of the ILCs themselves. Commercially-owned ILCs will therefore be subject to contagious losses of confidence, producing a greater likelihood of federal bailouts of their commercial owners.

As explained in Part 3, the FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs. In addition, any decision by Congress to designate the FDIC as consolidated regulator of such firms would have at least four adverse effects. First, the FDIC lacks the experience or the specialized expertise to identify and control the risks created by commercial owners of ILCs. Second, the FDIC's designation as consolidated supervisor would lead market participants to expect that the federal safety net would be available to support commercial parent companies of ILCs. Third, attempts by the FDIC to control the activities of commercial affiliates of ILCs would significantly increase the amount of governmental regulation of our general economy and would undermine the effectiveness of market-driven incentives. Fourth, large commercial owners of ILCs are likely to enjoy substantial political influence, which they could use to extract costly subsidies or forbearance measures from both Congress and federal bank regulators.

Policy Analysis

1. Commercial Ownership of ILCs Is Contrary to Our General Policy of Separating Banking and Commerce

Economists and legal scholars have long debated whether the United States has followed a general policy of separating banking institutions from commercial enterprises.[28] There have been times when banks invested in, or formed affiliations with, commercial enterprises. Indeed, failures of depository institutions involved with commercial activities triggered serious financial crises on several occasions. Each crisis led to legislation that imposed limitations on bank powers and affiliations in order to separate banks from general commercial activities. Congress also enacted laws on several occasions in order to close legal "loopholes" that allowed commercial firms to acquire significant numbers of FDIC-insured depository institutions. Thus, the clear trend in U.S. banking policy has been to separate banking from commerce, a trend that has grown stronger over time.

For example, the charters granted by the Pennsylvania legislature to the Bank of North America in 1787, and by Congress to the First and Second Banks of the United States in 1791 and 1816, barred those banks from engaging in commercial enterprises. The limitations contained in these early bank charters show that legislators were concerned about separating banking from commerce during the Republic's first three decades.[29] During the mid-19th century, state legislatures adopted "free banking" statutes that prohibited banks from engaging in commercial activities, and Congress followed the same approach in the National Bank Act of 1864. Those statutory constraints reflected a legislative reaction against the severe economic crisis of the early 1840s, which was precipitated by (i) the collapse of the Bank of the United States of Philadelphia and Morris Canal and Banking Company, following their aggressive expansion into commercial activities, and (ii) the failures of a number of state-chartered banks that

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[28] *See generally* Christine E. Blair, "The Future of Banking in America: The Mixing of Banking and Commerce," 16 *FDIC Banking Review* Nos. 3 & 4, at 97 (2004) (providing overview of debate).
[29] Wilmarth, supra note 1, at 1554-55.

financed or invested in real estate development, public works projects and other commercial ventures.[30]

The failures of several large financial-commercial conglomerates during 1930-33 – including Caldwell and Company, Bank of United States and the two largest Detroit banks – helped to persuade Congress to adopt the Banking Act of 1933 (1933 Act). The 1933 Act imposed significant restrictions on the activities and affiliations of banks. Sections 5(c) and 16 of the 1933 Act generally prohibited banks from making equity investments in nonbank corporations (except for authorized subsidiaries).[31] Additionally, he 1933 Act imposed strict limits on financial transactions between FRS member banks and their affiliates by adding a new Section 23A to the Federal Reserve Act.[32] Congress also authorized bank regulators to examine affiliates to evaluate their impact on the affairs of regulated banks.[33]

In response to the thrift debacle of the 1980s – including the failures of Lincoln Savings and other large thrift institutions that were heavily involved in real estate development and other commercial enterprises – Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[34] Among other things, FIRREA prohibited state-chartered thrifts from engaging as principal or investing

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[30] *See* Wilmarth, supra note 1, at 1554-58.

[31] 12 U.S.C. §§ 335, 24 (Seventh). The 1933 Act's restrictions on equity investments originally applied only to national banks and state banks that were members of the Federal Reserve System (FRS). However, similar restrictions were applied to FDIC-insured state nonmember banks in 1991. Wilmarth, supra note 1, at 1564,

[32] Section 23A places strict limits on the amount and terms of "covered transactions" – including extensions of credit and purchases of assets or securities – between a bank and its affiliates. 12 U.S.C. § 371a. Congress subsequently extended the provisions of Section 23A to reach FDIC-insured state nonmember banks. Wilmarth, supra note 1, at 1565. In 1987, Congress adopted Section 23B of the Federal Reserve Act, which imposes additional requirements and restrictions on transactions between banks and their affiliates. 12 U.S.C. § 371b; Wilmarth, supra note 1, at 1571.

[33] 12 U.S.C. §§ 338, 481. In 1966, Congress gave the FDIC similar authority to examine affiliates of FDIC-insured nonmember banks. Wilmarth, supra note 1, at 1565.

[34] Wilmarth, supra note 1, at 1573-79.

in activities that were not permissible for federal savings associations. After a wave of bank failures occurred in the late 1980s, Congress imposed similar limitations on the powers of state-chartered banks in 1991.[35] In addition, Congress required thrifts to comply with the restrictions on affiliate transactions contained in Section 23A and Section 23B of the Federal Reserve Act.[36] Congress also barred thrifts from making any loans or other extensions of credit to affiliates engaged in activities that were not permissible for bank holding companies under 12 U.S.C. § 1843(c).[37]

On four occasions since 1950, Congress has enacted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. When Transamerica and other commercial firms purchased numerous banks during the 1950s, Congress responded in 1956 by adopting the BHC Act, which prohibited multibank holding companies from engaging in activities that were not "closely related to banking."[38] When commercial conglomerates established a large number of one-bank holding companies in the late 1960s, Congress responded in 1970 by extending the BHC Act to reach those holding companies.[39] After commercial firms purchased dozens of FDIC-insured "nonbank banks" during the 1980s, Congress stopped the nonbank bank movement by adopting the Competitive Equality Banking Act of 1987 (CEBA).[40] After commercial firms acquired a substantial number of FDIC-insured thrift institutions in the 1990s, Congress barred further commercial acquisitions of thrifts by enacting the Gramm-Leach-Bliley Act of 1999 (GLBA).[41] On

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[35] Wilmarth, supra note 1, at 1580 (discussing 12 U.S.C. § 1831a).
[36] *Id.* at 1579 (discussing 12 U.S.C. § 1468(a)).
[37] *Id.* (discussing 12 U.S.C. § 1468(a)(1)(A)).
[38] *Id* .at 1566-67.
[39] *Id.* at 1567-69.
[40] *Id.* at 1569-71
[41] *Id.* at 1584-86

all four occasions, Congress declared that it acted in order to maintain a separation between banking and commerce.

Thus, the policy of separating banking and commerce has gained strength over time and has operated with particular force since 1956. It is true that the Federal Reserve Board (FRB) could undermine that policy by adopting expansive interpretations of GLBA's provisions allowing financial holding companies to engage in merchant banking, "financial in nature" activities, or activities that are "incidental" or "complementary" to financial activities. However, in enacting GLBA, Congress instructed the FRB to approve such activities in a carefully limited manner that would "maintain the separation between banking and commerce."[42] Congress gave the FRB a veto power over the scope of merchant banking, "financial in nature" and "incidental" activities, and Congress gave the FRB sole authority to determine the scope of "complementary" activities. In assigning these gatekeeping roles to the FRB, Congress presumably intended that the FRB would perform those roles in a conservative manner based on the FRB's longstanding policy position against mixing banking and commerce.[43]

The one significant remaining exception to the congressional policy of separating banking and commerce is the provision of CEBA that allows commercial firms to acquire FDIC-insured ILCs.[44] The legislative history of CEBA does not explain why Congress

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[42] *Id.* at 1582 n.254 (quoting H.R. Rep. No. 106-74, pt. 1, at 122 (1999)); *see also id.* at 1583 n.259 (quoting 145 Cong. Rec. S13788 (daily ed. Nov. 3, 1999) (remarks of Sen. Sarbanes), and 145 Cong. Rec. H11527 (daily ed. Nov. 4, 1999) (remarks of Rep. Leach)).

[43] *Id.* at 1582-84.

[44] *See id.* at 1550, 1572. CEBA also exempted limited-purpose trust companies and credit card banks from the definition of "bank" under the BHC Act and thereby permitted commercial firms to acquire such institutions. However, CEBA imposed stringent limitations that effectively prevent limited-purpose trust companies and credit card banks from engaging in a retail banking business or from making commercial loans. *See id.* at 1571.

decided to exempt ILCs from the BHC Act's prohibition on commercial ownership of FDIC-insured depository institutions.[45] However, former Senator Jake Garn of Utah, a co-sponsor of the ILC exemption, explained his personal view of that exemption when he testified during the FDIC's public hearings in April 2006 on Wal-Mart's application to acquire an ILC. Senator Garn declared that he would strongly oppose any attempt by Wal-Mart to "expand their application" to offer retail banking services at Wal-Mart stores, because "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."[46]

Senator Garn's testimony indicates a congressional understanding in 1987 that ILCs would not be used as a platform for large commercial firms to offer full-service banking to consumers at the parent companies' retail outlets. In 1987, ILCs were small state-chartered institutions that had limited deposit-taking powers and engaged principally in making consumer loans to middle-income and lower-income individuals. Thirteen ILCs failed during 1982-84, and Utah imposed a moratorium on chartering new ILCs in 1987.[47] The total assets of all ILCs in 1987 were only $4.2 billion, and the

[45] The exemption for ILCs was contained in a managers' amendment, which was co-sponsored by Senators William Proxmire and Jake Garn and was approved during the Senate floor debates on CEBA. 133 Cong. Rec. S 3810, S 3813 (daily ed., Mar. 25, 1987) (remarks of Sen. Proxmire). Senators who discussed the ILC exemption and the conference committee report simply summarized the statutory terms of the ILC exemption and did not explain its underlying purpose or intended scope. *See id.* at S 3813 (remarks of Sen. Proxmire); *id.* at S 3957 (daily ed. Mar. 26, 1987) (colloquy between Sen. Inouye and Sen. Proxmire); H.R. Rep. No. 100-261, at 121 (1987) (Conf. Rep.), reprinted in 1987 U.S.C.C.A.N. 588, 592.

[46] Oral Testimony of Hon. Edwin J. "Jake" Garn, FDIC Hearings on Wal-Mart Application, April 10, 2006 (Panel 8), at 8, 12.

[47] Testimony of FRB General Counsel Scott G. Alvarez before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, July 12, 2006 (available at federalreserve.gov/boarddocs/textimony/2006/20060712/default.htm), at 5; Bill McConnell, Utah to End Freeze on Charters for Industrial Loan Companies, *American Banker*, April 3, 1997, at 3 (stating that Utah imposed a "freeze" on new ILC charters in 1987, "following a wave of failures"); Barry Stavro, As Good as Their Word, Forbes, Feb. 25, 1985, at 52.

largest ILC had less than $420 million of assets.[48] In 1993, a Congressional Research Service report stated that ILCs played only a "minor" role in the U.S. financial system.[49]

However, ILCs have expanded rapidly in recent years, due in part to the liberalization of state laws governing ILCs. For example, Utah amended its laws in 1997 to give ILCs virtual parity with state-chartered commercial banks (except for the ability to offer demand deposits).[50] In addition, GLBA encouraged commercial firms to seek ILC charters, because GLBA barred commercial firms from making any further acquisitions of thrift institutions. During 1999-2006, total assets held by ILCs grew from $44 billion to $177 billion. Currently, the largest ILC (owned by Merrill Lynch) holds more than $60 billion of assets, and commercial firms own fifteen ILCs.[51]

Thus, the ILC industry has changed dramatically since Congress enacted CEBA in 1987. The FDIC recently stated that the business plans prepared by Home Depot and other proposed commercial owners of ILCs "differ substantially from the consumer lending focus of the original industrial banks."[52] When CEBA was passed, Congress evidently did not appreciate the potential threat that the ILC exemption would pose to the policy of separating banking and commerce.

Congress' lack of awareness of the potential impact of the ILC exemption becomes clearer when one considers that CEBA closed the "nonbank bank loophole." CEBA was expressly designed to prevent retailers and other commercial firms from

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[48] FDIC Moratorium Notice, supra note 6, at 43482.

[49] William Jackson, "Mixing Banking and Commerce Using Federal Deposit Insurance: Industrial Banks and Nonbank Banks," *Congressional Research Service Report* 93-769 E, Aug. 26, 1993, at n.7 and accompanying text (stating that ILCs had only $7 billion of assets at the end of 1992, while U.S. commercial banks and trust companies held $3.5 trillion of assets).

[50] Utah liberalized its ILC statutes and authorized the chartering of new ILCs in 1997. *See* McConnell, supra note 47. For discussions of the Utah laws governing ILCs, *see* GAO-ILC Report, supra note 9, at 21-22, 24-25; FDIC Proposed Rule on Consolidated Supervision, supra note 17, at 5221 n.32.

[51] Wilmarth, supra note 1, at 1573.

[52] FDIC Moratorium Extension Notice, supra note 2, at 5291.

continuing to acquire FDIC-insured “nonbank banks.”[53] The Senate committee report on CEBA declared that “[n]onbank banks undermine the principle of separating banking and commerce, a policy that has long been the keystone of our banking system. . . . The separation of banking and commerce helps ensure that banks allocate credit impartially, and without conflicts of interest.”[54] It is highly improbable that Congress decided to close the “nonbank bank loophole” in 1987 for the specific purpose of preserving the separation of banking and commerce but, at the same time, inserted the ILC exemption with the conscious goal of undermining the same policy.

2. Commercially-Owned ILCs Pose Significant Risks to the U.S. Financial System and General Economy

For at least three reasons, continued acquisitions of ILCs by commercial firms are likely to create serious risks for our nation’s financial system and general economy. First, ownership of ILCs by large commercial firms is likely to spread the federal safety net and “too big to fail” (TBTF) subsidies from the financial sector to the commercial sector of the economy. The ability of commercial owners of ILCs to gain access to low-cost, FDIC-insured funds will increase the risks to the deposit insurance fund and will create competitive inequities between commercial firms that control ILCs and those that do not. Ownership of a large ILC by a giant commercial firm would place great pressure on federal regulators to provide financial support if either the ILC or its parent company was threatened with failure.

Second, commercially-owned ILCs are subject to conflicts of interest that encourage them to make loans and investments to benefit their commercial affiliates. As shown by the financial history of the United States and other nations, preferential

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[53] Wilmarth, supra note 1, at 1569-71.
[54] S. Rep. No. 100-19, at 8, as reprinted in 1987 U.S.C.C.A.N. at 498.

transfers of funds from banks to commercial affiliates or their customers create significant risks for the deposit insurance fund and also increase the likelihood of a systemic economic crisis. In addition, such transfers provide commercial owners of ILCs with an unfair competitive advantage over firms that do not have bank affiliates.

Third, problems arising at commercial owners of ILCs are likely to create public concerns about the soundness of the ILCs. Commercially-owned ILCs will therefore be subject to contagious losses of confidence resulting from problems at their commercial parent companies. In turn, such losses of public confidence will produce a greater likelihood of TBTF bailouts.

a. Extension of the Federal Safety Net and TBTF Subsidies to Commercial Owners of ILCs

During the 1990s, scholars, regulators and lawyers debated whether the federal "safety net" for financial institutions provided a net subsidy to banks.[55] Those who denied the existence of a net subsidy argued that the costs of banking regulation exceeded the value of any safety net subsidy.[56] However, a more recent study concluded that safety net subsidies have increased since the mid-1990s and probably do provide a net subsidy to most banks.[57] Similarly, the General Accountability Office (GAO) stated in 2005 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

[55] The federal "safety net" for financial institutions consists of (i) federal deposit insurance, (ii) protection of 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* 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* (Benton E. Gup, ed. 2004), at 169, 179-83; John R. Walter, "Can a Safety Net Subsidy Be Contained?", 84 *Economic Quarterly* No. 1, Fed. Res. Bank of Rich., VA, at 1, 2 (1998).

[56] For helpful overviews of this debate, s*ee* Patricia A. McCoy, *Banking Law Manual* § 4.02 at 4-12 (2d ed. 2006); Peek & Wilcox, supra note 55, at 184-87.

[57] Peek & Wilcox, supra note 55, at 170, 187-90.

of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers."[58]

During a systemic crisis, the safety net subsidy is likely to become very large because the federal government, in effect, provides "catastrophe insurance."[59] If the deposit insurance fund is inadequate to cover the cost of resolving failed banks, the federal government has shown a willingness to mobilize taxpayer funds to prevent a collapse of the financial system.[60] For example, during the thrift and banking crises of 1980-94, the deposit insurance funds for banks and thrifts spent $64 billion in resolving the failures of nearly 3,000 thrifts and banks. The thrift deposit insurance fund was wiped out, and Congress used $132 billion of taxpayer funds to cover the full cost of resolving thrift failures. The bank insurance fund was depleted to the point of insolvency, and Congress expanded the FDIC's line of credit at the Treasury from $5 billion to $30 billion.[61] Many other nations have similarly provided extensive assistance to banks and generous protection to bank depositors during systemic financial crises in the 1980s and 1990s.[62] Most recently, U.K. authorities announced a blanket guarantee of bank deposits and provided financial support to Northern Rock, a large mortgage lender,

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[58] GAO-ILC Report, supra note 9, at 71-72.
[59] Peek & Wilcox, supra note 55, at 180.
[60] *Id.* at 180-81.
[61] Resolving the failures of 1,300 thrifts required (i) $28 billion of funds from the FSLIC deposit insurance fund for thrifts and (ii) $132 of taxpayer funds. Resolving the failures of 1.600 banks required $36 billion from the FDIC's bank insurance fund, which left the fund effectively insolvent in 1991. At that point, Congress provided the FDIC with authority to borrow up to $30 billion from the Treasury (an authority that the FDIC ultimately did not have to use). *See* Wilmarth, supra note 1, at 1589 & n. 290.
[62] *See id.* at 1589, 1599-1606; Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* 40, 75-77 (2004).

in order to stop a run by Northern Rock's depositors.[63] Thus, the subsidy provided by the federal safety net increases greatly in magnitude during a financial crisis.

Whether or not small banks enjoy a subsidy, many analysts believe that the safety net provides significant subsidies to large banks that are viewed as TBTF by the financial markets. For example, Countrywide recently faced a serious liquidity squeeze when the securitization and credit markets cut off funding for nonprime mortgage loans. Countrywide survived because it could call upon funding from (i) FDIC-insured deposits held by its federally-chartered thrift subsidiary, and (ii) advances from the Federal Home Loan Bank System. Additionally, some commentators believe that the FRB quietly encouraged large banks to provide emergency funding to Countrywide. In contrast, dozens of smaller, nondepository subprime lenders went out of business during the past year after they lost access to funding from the securitization and credit markets.[64]

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 nonbank 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) banks achieve higher credit ratings and pay lower interest rates on their bonds as they grow in size to achieve TBTF status.[65] Indeed, the TBTF subsidy

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[63] *See* Kate Burgess et al., "Week that shook the banking world," *Financial Times*, Sept. 22, 2007, at 3; Stanley Reed, "Subprime Tremors: Suddenly, a Bank Run in Britain," *Business Week*, Oct. 1, 2007, at 40.

[64] *See* Kate Berry, "Thrift Unit Buttresses Countrywide's Continuity," *American Banker*, Sept. 10, 2007, at 20; Maria Bartiromo, "The Mortgage Mess: The Heat on Countrywide," *Business Week*, Sept. 10, 2007, at 28; James R. Hagerty, "Countrywide Is to Cut 20% of Work Force," *Wall Street Journal*, Sept. 8, 2007, at B1; James R. Hagerty & Lingling Wei, "Countrywide Seeks Deposits to Fund Loans," *Wall Street Journal*, Sept. 19, 2007, at A4..

[65] *See, e.g.*, Stern & Feldman, supra note 62, at 30-39; Edward J. Kane, "Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?", 32 *Journal of Money,*

has been an important motivating factor behind the rapid consolidation that has taken place in the U.S. banking industry over the past two decades.[66]

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 operate as a nonbank.[67] In contrast, large nonbanking companies have consistently sought to gain control of FDIC-insured depository institutions. Securities firms, life insurance companies and commercial firms acquired nonbank banks before the nonbank bank loophole was closed in 1987, and they also acquired thrifts before the unitary savings and loan holding company loophole was closed in 1999. Each of the four largest U.S. securities firms – Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers – owns a Utah-chartered ILC. Currently, thirty-three insurance companies own some type of bank, while fifteen commercial firms own ILCs. If the costs of bank regulation actually exceed the benefits provided by the federal safety net, it is very difficult to understand why no major bank has ever given up its charter, and why so many nonbanking companies have been so eager for so long to acquire a financial institution charter that will enable them to offer FDIC-insured deposits to their customers. In my

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Credit & Banking 671 (2000) [hereinafter Kane, "Megamerger Incentives"], at 673-74, 691-95; George Pennacchi, "Deposit insurance, bank regulation, and financial system risks," 53 *Journal of Monetary Economics* 1, 14-16 (2005); Donald P. Morgan & Kevin J. Stiroh, "Too Big to Fail after All These Years," Fed. Res. Bank of NY Staff Rep. No. 220, Sept. 2005 (available at http://ssrn.com/abstract=813967), *passim*; Maria F. Penas & Haluk Unal, "Gains in bank mergers: Evidence from the bond markets," 74 *Journal of Financial Economics* 149, 150-51, 155, 159, 161-62, 168, 170-71 (2004).

[66] *See ,e g.*, Stern & Feldman, supra note 62, at 32-33, 60-79; Gerald A. Hanweck & Bernard Shull, "The Bank Merger Movement: Efficiency, Stability and Competitive Policy Concerns," 44 *Antitrust Bulletin* 251, 273-79 (1999); Kane, "Megamerger Incentives," supra note 65, at 673-74. 683-95; Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks," 2002 *University of Illinois Law Review* 215, 300-12 (2002) [hereinafter Wilmarth, "Transformation"].

[67] Wilmarth, "Transformation," supra note 66, at 447 n.1033.

view, banks and nonbanking companies have indisputably proven the existence of a safety net subsidy – at least for large financial institutions – by voting with their feet.[68]

Merrill Lynch is a leading example of a nonbank financial institution that has reaped significant benefits from its access to the federal safety net. Merrill acquired a thrift institution and an ILC during the 1990s. In 2000, Merrill introduced a "sweep account" program in order to transfer its customers' cash balances from uninsured brokerage accounts into FDIC-insured deposits in its subsidiary depository institutions. By 2006, Merrill's banks held $80 billion in deposits, and Merrill used those deposits to fund $70 billion of commercial and consumer loans. Citigroup's Smith Barney brokerage unit and other major securities brokers have introduced similar sweep account programs to move customer cash balances into FDIC-insured deposits at their affiliated banks.[69]

A 2004 study estimated that sweep account programs created $350 billion of FDIC-insured deposits that otherwise would have been held in uninsured money market mutual funds (MMMFs) at brokerage firms.[70] Securities firms with bank affiliates have established these sweep programs because FDIC-insured deposits pay interest rates that are much lower, and earn spreads that are much higher, than the rates and spreads applicable to uninsured MMMFs.[71] A comment letter submitted by the Securities Industry Association (SIA) to the FDIC in 2006 confirms the significant benefits produced by sweep programs:

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[68] Wilmarth, supra note 1, at 1590-91.

[69] Pennacchi, supra note 65, at 15 & n.21; Wilmarth, supra note 1, at 1591.

[70] Pennacchi, supra note 65, at 15 (citing study by Crane and Krasner).

[71] *Id.* at 15-16; Wilmarth, "Transformation," supra note 66, at 448 & n.1035. Unlike bank deposits, which can be used to fund commercial and consumer loans, MMMFs may only invest in highly-rated securities with an average maturity of not more than 90 days. Timothy Q. Cook & Jeremy G. Duffield, "Money Market Mutual Funds and Other Short-Term Investment Pools," in *Instruments of the Money Market* (Fed. Res. Bank of Rich., VA, 7th ed. 1993), at 156, 165-67.

> Bank subsidiaries have added significant value and versatility to SIA member corporate groups, because SIA member owned banks hold idle funds swept from brokerage accounts [into] deposits. . . . This has provided a reliable and low cost source of deposits to fund traditional banking products and services offered to customers of the corporate group . . . . The most cost effective way to fund bank quality loans is with deposits.[72]

Many commentators believe that GLBA has extended TBTF protection to the nonbank affiliates of large financial conglomerates that control banks.[73] Owners of major commercial firms might reasonably expect that they, too, will receive TBTF treatment if they acquire ILCs and expand the assets of their ILCs as rapidly as Merrill has done.[74] If Wal-Mart, the world's largest retailer, and Home Depot, the second largest U.S. retailer, acquired ILCs and opened deposit-taking branches in many of their stores, they could probably match or improve on Merrill's deposit-taking performance.[75]

Given the immense size of both Wal-Mart and Home Depot, it seems inconceivable that federal regulators would allow either company to collapse if it owned a large FDIC-insured ILC. Wal-Mart accounts for eight percent of domestic retail sales and two percent of the gross domestic product. On several occasions since 1970, the federal government has intervened to save or reorganize a company or industry whose

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[72] Letter to the FDIC, dated Oct. 10, 2006, from the Securities Industry Ass'n, at 3, Comment No. 71 in Comments on Industrial Loan Companies and Industrial Banks (available at www.fdic.gov/regulations/laws/federal/2006/06comilc.html) [hereinafter Comments to the FDIC on ILCs].

[73] Henry Kaufman, *On Money and Markets: A Wall Street Memoir* 209-10, 237-40 (2000); Stern & Feldman, supra note 62, at 70-77; Wilmarth, "Transformation," supra note 66, at 303-04, 446-50, 474-75.

[74] The Federal Reserve Board (FRB) has authority extend discount window loans to any nonbanking company "in unusual and exigent circumstances." 12 U.S.C. § 343. Section 343 would permit the FRB to provide financial support to any nonbanking firm whose survival is deemed necessary to maintain the stability of the financial markets. *See* Henry T.C. Hu, "Faith and Magic: Investor Beliefs and Government Neutrality," 78 *Texas Law Review* 777, 873-75 (2000); Wilmarth, "Transformation," supra note 66, at 304 & n.369.

[75] Wal-Mart operates some 3,300 stores in the United States and about 6,700 stores globally. During its 2006 fiscal year, Wal-Mart produced domestic sales of $326 billion and global sales of $349 billion, making it the largest retailer in the United States and the world. Home Depot operates more than 2,100 stores in the United States and generated total sales of $91 billion in 2006, making it the second largest U.S. retailer. Wilmarth, supra note 1, at 1592-93 n.309.

survival was deemed important to the national interest.[76] On at least four other occasions during that period, the FRB has taken action to maintain the stability of the financial markets after the failure of a major nonbanking firm.[77] Given those precedents, acquisitions of ILCs by Wal-Mart, Home Depot and other giant commercial firms will significantly increase the likelihood and potential costs of similar federal interventions in the future.

Based on the foregoing considerations, it seems clear that (i) large commercial owners of ILCs will obtain substantial financial benefits from the federal safety net, particularly in the form of low-cost deposits and implicit catastrophe insurance, and (ii) those commercial firms will have a significant funding advantage – and therefore an important competitive edge – over competitors that do not own ILCs.[78] Unless acquisitions of ILCs by commercial firms are prohibited, many large commercial entities will probably deem it essential to acquire ILCs in order to maintain competitive parity with those firms that already own ILCs. Thus, over time, acquisitions of ILCs by large commercial firms will almost certainly create serious distortions within the general economy.

b. Conflicts of Interest, Preferential Lending and Systemic Risk

i. Evidence from the United States

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[76] *See id.* at 1593 n. 311 (discussing (i) federal support for the reorganization of railroads following Penn Central's bankruptcy in 1970, (ii) federal loan guarantees given to Lockheed in 1971 and Chrysler in 1980, and (iii) federal payments and loan guarantees provided to airlines after the terrorist attacks on September 11, 2001).

[77] *See id.* at 1592 n. 312 (citing the FRB's interventions to stabilize the financial markets following (i) the collapse of Penn Central in 1970, (ii) the Hunt Brothers' failed attempt to corner the silver market in 1980, (iii) the stock market crash in 1987, and (iv) the collapse of Long Term Capital Management (LTCM) in 1998).

[78] *See* GAO-ILC Report, supra note 9, at 71-72.

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. As shown above, ILCs enjoy a significant funding advantage over nonbanking 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 affiliate encounters financial problems. For example, when Caldwell and Company (a financial-commercial conglomerate that failed in 1930) 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.[79] Similarly, Bank of United States failed in 1930 after it made large loans to support its securities and real estate affiliates.[80]

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. In the late 1980s, American Continental used the branches and employees of Lincoln Savings to promote

[79] Wilmarth, supra note 1, at 1560-61, 1576-78. Similarly, when Drexel Burnham was threatened with failure in early 1990, it made capital withdrawals from its regulated securities subsidiaries in excess of regulatory limits until the SEC intervened to prevent further capital transfers. Wilmarth, "Transformation," supra note 66, at 456 n.1058; *see also* Jonathan Brown, *The Separation of Banking and Commerce* (available at www.public-gis.org/reports/sbc.html), at 25 (quoting SEC chairman Richard Breeden's Senate testimony concerning Drexel Burnham's failure, in which Mr. Breeden acknowledged that the SEC did not fully appreciate the "risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors"). [Note: Mr. Brown's paper is undated, but evidently it was written in 1990. *See id.* at 34, 41.]
[80] Wilmarth, supra note 1, at 1561-62.

the sale of the American's uninsured subordinated notes to more than twenty thousand customers. Those customers suffered severe losses when Lincoln failed and American filed for bankruptcy.[81] Similarly, in the early 1970s, Beverly Hills Bancorp sold $12.5 million of commercial paper to more than two hundred customers of its subsidiary bank, Beverly Hills National Bank. After the parent company defaulted on the commercial paper, the customers sued the bank and forced it into conservatorship and liquidation.[82]

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.[83] Commercial firms can similarly use their ILCs to extend credit to customers to promote the sale of the parent's products.[84] For example, Volkswagen, Target and Toyota acquired Utah ILCs during 2002-04. The primary business of Volkswagen Bank and Toyota Financial Savings Bank is to make loans to consumers and businesses to finance purchases of automobiles produced by their parent companies. Similarly, Target Bank issues proprietary credit cards to business firms to facilitate their purchases of goods at Target stores.[85]

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[81] *Id.* at 1577-78.

[82] *Id.* at 1594-95, 1607.

[83] *See* Brown, supra note 79, at 5-6, 9, 12-13 (stating that, prior to the enactment of the 1970 amendments to the BHC Act, federal examiners discovered that a commercial bank controlled by Sears "had a heavy concentration of its commercial loans to firms that were Sears' suppliers," *id.* at 9); *see also* GAO-ILC Report, supra note 9, at 72.

[84] Brown, supra note 79, at 5-6, 12-13; *see also* GAO-ILC Report, supra note 9, at 72.

[85] Statement of Douglas H. Jones, supra note 12, at 3, 12-14 (attach. 1). A recent comment letter submitted to the FDIC by two ILC trade associations explained how an ILC can provide credit to customers of its parent company in compliance with Sections 23A and 23B. The comment letter stated that an ILC can lawfully make loans to its parent's customers as long as the parent either (i) buys the customer loans from the ILC without recourse, or (ii) maintains a cash deposit at the ILC equal to the amount of outstanding customer loans. *See* Letter to the FDIC, dated Oct. 10, 2006, from the Utah Ass'n of Financial Services and the Calif. Ass'n of Industiral Banks, at 12, 33-34, Comment No. 109 in Comments to the FDIC on ILCs, supra note 72. If the letter is correct, a commercial parent company can call upon its ILC to provide unlimited credit to the parent's customers as long as the parent company is willing to cover the credit risk associated with those loans. However, that arrangement provides relatively little comfort to the federal deposit insurance fund and to taxpayers, because excessive and unsound loans to customers could inflict crippling losses on the parent company. In turn, problems at the parent companiy of a financial institution

Home Depot has filed an application to acquire a Utah ILC called EnerBank. EnerBank's proposed business plan is to make installment loans to consumers who hire EnerBank-approved contractors for home improvement projects. Home Depot hopes that EnerBank's loans will encourage approved contractors to purchase materials for home improvement projects at Home Depot stores. Although Home Depot claims that contractors will not be compelled to buy their materials at Home Depot stores, contractors cannot participate in the program unless they are approved by EnerBank as "loan program sponsors." It certainly seems doubtful whether a contractor would retain its status as an approved EnerBank "sponsor" if it failed to buy a significant portion of its materials from Home Depot.[86]

Thus, the existing and proposed business plans of commercially-owned ILCs reflect a consistent strategy among commercial firms to promote the sale of their products by using the credit facilities of their captive ILCs. Advocates for commercial ownership of ILCs argue that "firewalls" established by laws restricting affiliate transactions and insider lending will prevent an ILC from making unsound loans or abusive transfers of funds to benefit its commercial affiliates.[87] As noted above, Sections 23A and 23B of the Federal Reserve Act impose quantitative limits and collateral requirements on affiliate transactions, prohibit bank purchases of low-quality assets from affiliates, and require affiliate transactions to be conducted on arms' length terms.[88] In addition, federal statutes and regulations impose strict conditions on loans made by any FDIC-insured

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are likely to undermine public confidence in the subsidiary institution. *See* Wilmarth, supra note 1, at 1606-13.

[86] Wilmarth, supra note 1, at 1595-96.

[87] *See, e.g.*, Blair, supra note 28, at 98-99, 103-04; Statement of Lawrence J. White, in FDIC Hearings on Wal-Mart Application, April 11, 2006 (Panel 3), at 4-11.

[88] 12 U.S.C. §§ 371a & 371b..

bank to its directors, executive officers and principal shareholders and their related interests.[89]

However, these 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 1980 involved violations of rules governing affiliate transactions and insider lending.[90] Similarly, a 1994 GAO study found that unlawful insider lending and abusive affiliate transactions occurred at a significant proportion of 175 banks that failed during 1990-91.[91] 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.[92] Hamilton National Bank 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.[93] During the 1987 stock market crash, Continental Illinois violated legal lending limits in order to prevent its options trading subsidiary from failing.[94]

Two large FDIC-insured ILCs have failed since 1999, resulting in losses to the deposit insurance fund of more than $100 million.[95] In each case, the corporate parent and the ILC operated in a unitary fashion that did not maintain any meaningful corporate separation, and the parent and the ILC engaged in transactions that violated Sections 23A

89 *See* McCoy, supra note 56, § 14.04[1][d] (discussing restrictions on loans to insiders under 12 U.S.C. §§ 375a, 375b, 1468(b) and 1828(j)(2) and the regulations adopted thereunder).
90 Wilmarth, supra note 1, at 1575-77.
91 Catharine M. Lemieux, "Conglomerates, Connected Lending and Prudential Standards: Lessons Learned," 4 *UCLA Journal of International and Foreign Affairs* 149, 157-58 (1999) (stating that the GAO study found violations of insider lending rules at 82 of the 175 failed banks and also found preferential insider loans at 70 banks and improper affiliate transactions at 49 banks).
92 *See* Joseph F. Sinkey , Jr., *Problem and Failed Institutions in the Commercial Banking Industry* 218-33 (1979).
93 *Id.* at 198-205.
94 Wilmarth, "Transformation," supra note 66, at 456 n.1058.
95 GAO-ILC report, supra note 9, at 59-60 (discussing failures of Pacific Thrift and Loan in 1999 and Southern Pacific Bank in 2003).

and 23B. While the violations of Sections 23A and 23B were not the primary reason for the ILCs' failures, those violations were symptomatic of fundamental inadequacies in the management policies, audit practices and compliance procedures of both institutions.[96] The foregoing evidence from thrift, bank and ILC failures creates serious doubts about the effectiveness of restrictions on affiliate transactions and insider lending in preventing abusive and unsound transactions between ILCs and their corporate owners.[97]

Moreover, the restrictions in Sections 23A and 23B are complex and difficult to enforce, and managerial evasions of those provisions are often subtle and difficult to detect.[98] The challenges of detecting abusive affiliate transactions are magnified when a large commercial firm controls an FDIC-insured bank. As one analyst observed:

> Given that the banking regulators are already overburdened with the task of controlling bank soundness, it is quite unrealistic to expect them to monitor and detect more subtle bias in the vast array of loans that banks would make to commercial affiliates, their suppliers and their customers if the mixing of banking and commerce were permitted.[99]

The debacles at Lincoln Savings and Enron demonstrate how complex structures can be used to mask manipulative transactions with affiliates. The parent company of Lincoln Savings caused the thrift to enter into complicated deals involving sham sales of assets to "straw" buyers. Those deals generated fictitious accounting "profits," which Lincoln then transferred to its parent pursuant to an abusive "tax sharing agreement."[100] Similarly, Enron entered into a myriad of commodity swaps and sales of assets with off-

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96 *Id.* at 59-61; Wilmarth, supra note 1, at 1597.
97 *See* GAO-ILC Report, supra note 9, at 61 (reporting the view of FRB officials that "focusing supervisory efforts on transactions covered by sections 23A and 23B will not cover the full range of risks that insured institutions are exposed to from holding companies and their subsidiaries").
98 Wilmarth, "Transformation," supra note 66, at 456, 457 n.1060; *see also* Lemieux, supra note 91, at 154-57.
99 Brown, supra note 79, at 6-7; *see also id.* at 44 (stating that "serious questions arise as to the [federal banking] agencies' ability to prevent preferential lending and unsound loans in situations where conflicts of interest or external pressures impinge on the credit judgment process").
100 Wilmarth, supra note 1, at 1577.

balance-sheet, special–purpose entities that were purportedly independent but were actually controlled by Andrew Fastow, Enron's chief financial officer. Like the Lincoln Savings transactions, Enron's structured-finance deals were elaborate shams that were created for the purpose of producing fictitious profits and deceiving credit ratings agencies and institutional investors.[101] The Lincoln and Enron scandals raise further questions concerning the ability of federal regulators and market professionals to identify and evaluate transactions that are designed to benefit affiliates but are disguised by complex financial structures.

Perhaps most disturbing is the possibility that federal regulators might decide to waive affiliate transaction rules so that ILCs could support their commercial affiliates during a major crisis. After the terrorist attacks on September 11, 2001, federal regulators suspended the application of Section 23A and encouraged major banks to transfer large amounts of funds to their securities affiliates to prevent a liquidity crunch that could have paralyzed the securities markets and threatened the survival of leading securities firms.[102] Similarly, in August 2006, the FRB granted temporary waivers to the three largest U.S. banks (Citigroup, Bank of America and JP Morgan Chase) so that those institutions could make large fund transfers in excess of Section 23A limits to support their securities affiliates during the subprime funding squeeze.[103] The ownership of ILCs by huge commercial firms increases the likelihood that regulators would similarly feel compelled to waive legal restrictions on affiliate transactions whenever the parent

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[101] *See* Arthur E. Wilmarth, Jr., "Conflicts of Interest and Corporate Governance Failures at Universal Banks during the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom," George Washington University Law School Legal Studies Research Paper No. 234, Nov. 20, 2006 (available at ssrn.com/abstract=952486), at 10-20.

[102] Wilmarth, "Transformation," supra note 66, at 456-57, 472-73.

[103] Rob Blackwell, "Fed Allows JP Morgan Chase Transaction," *American Banker,* Aug. 29, 2007, at 3; Barbara A. Rehm, "Fed Lets 2 Banks Lend to Affiliates," *American Banker,* Aug. 27, 2007, at 20.

company's survival is threatened, because of concerns that the parent's failure could trigger a major economic crisis.

ii. Evidence from Japan, South Korea and Mexico

Major financial crises occurred in Japan, South Korea and Mexico during the 1990s. Each of those crises was due in part to ownership and control links that existed between banks and commercial firms. Each episode indicates that joint control of banks and commercial firms creates conflicts of interest, distorts economic incentives and increases the risk of a systemic crisis.

Analysts have offered many reasons for the severity and prolonged nature of the economic and financial crisis that afflicted Japan during 1990-2005. Three of those reasons are relevant to this analysis. First, the cross-shareholding relationships between Japanese banks and their corporate lending customers meant that the financial and commercial sectors in Japan were closely linked in 1989. Problems arising in one sector inevitably spilled over into the other. The tightly interwoven ownership and credit linkages between banks and their commercial customers significantly increased Japan's vulnerability to a systemic economic crisis.[104]

Second, due to the tremendous financial and political costs of dealing with the banking crisis, Japanese regulators and politicians adopted a variety of forbearance measures designed to postpone the day of reckoning. In this regard, they acted in a manner that was very similar to the actions of U.S. regulators and politicians during the savings and loan crisis of the 1980s. Japanese officials did not directly confront the banking industry's problems until large banks began to fail in 1997-98.[105]

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[104] Wilmarth, supra note 1, at 1599-1600; Wilmarth, "Transformation," supra note 66, at 451-53.
[105] Wilmarth, supra note 1, at 1600.

Third, in order to avoid recognizing loan losses and to support their most important borrowers, Japanese banks followed a policy of "evergreening" – *i.e.*, banks kept rolling over or restructuring loans that were in default. A recent study found that, during 1993-99, Japanese banks were more likely to "evergreen" loans if (i) they had a large credit exposure to the borrower, (ii) the borrower was a member of the bank's corporate group (*keiretsu*), (iii) the borrower was in weak condition, or (iv) the borrower did not have access to the bond markets and was therefore dependent on bank loans. Thus, a major reason for the Japanese economy's failure to improve during the 1990s was that main banks focused their lending on borrowers that were in the weakest condition and were most closely connected to the banks. As a consequence, bank credit was misdirected toward "zombie" firms, and credit was denied to more profitable firms that did not have close connections to banks.[106] In sum, Japan's experience indicates that control linkages between banks and commercial firms seriously distort the allocation of credit, increase the economy's vulnerability to systemic crises and impede the economy's ability to recover from an economic downturn.

South Korea's financial crisis of 1997-98 offers striking parallels to Japan's travails. Like Japan, South Korea maintained a bank-centered financial system from the 1950s through the 1990s, and South Korea's system contained similar cross-shareholding networks and lending relationships between large banks and major corporate groups (*chaebol*). As the government progressively liberalized its financial regulations during the 1990s, Korean commercial banks and newly-organized merchant banks continued to

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[106] Joe Peek & Eric Rosengren, "Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan," 95 *American Economic Review* 1145, 1150-65 (2005); *see also* Richard J. Caballero, Takeo Hoshi & Anil K. Kashyap, "Zombie Lending and Depressed Restructuring in Japan," National Bureau of Economic Research Working Paper 12129, Mar. 2006, *passim*.

expand their lending to Korean businesses. By the mid-1990s, the thirty largest *chaebol* were highly leveraged, as their average debt-equity ratio exceeded 500 percent. The *chaebol* relied on overly-generous bank credit to build up excess capacity in steel, shipbuilding, automobiles and semiconductors – industries that were vulnerable to competition from lower-cost foreign suppliers. Korean banks were also fragile, because they relied heavily on loans from foreign banks. Thus, both the *chaebol* and their Korean bank sponsors were highly vulnerable to a sudden withdrawal of international credit.[107]

The economic crisis that struck Thailand, Indonesia and Malaysia in 1997 led to increasing concerns among foreign investors and foreign banks about the solvency of Korean banks and businesses. Foreign banks reduced their credit lines to Korean borrowers, and foreign investors began to liquidate their Korean investments. The Korean stock market crashed, leading to a wave of corporate failures. In 1998, two large banks failed and were nationalized by the South Korean government, and the government also provided support for five acquisitions of other failing banks. The government protected all depositors and ultimately spent about $100 billion to restructure and recapitalize the Korean banking system.[108]

Thus, the Korean crisis of 1997-98, like the Japanese debacle, can be attributed in substantial part to incestuous ownership and credit links between banks and large corporate groups. Korean banks and Japanese banks extended credit to their principal corporate borrowers long past the point of prudence. Similarly, preferential lending by banks to related entities was an important factor in the Mexican financial crisis of 1994-95. Like the Korean banks, Mexican banks relied heavily on foreign credit to expand

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[107] Wilmarth, supra note 1, at 1601-02.
[108] *Id.* at 1602-03.

their loans to Mexican businesses and consumers. In addition, the banks extended many of their loans to controlling shareholders and their affiliates. Accordingly, the banks were highly vulnerable to a downturn in the Mexican economy in 1994.[109]

In response to the exchange rate crisis that began in December 1994, the Mexican government devalued the peso and imposed highly restrictive monetary and credit policies. The government's policies produced a dramatic rise in interest rates. Higher interest rates and the peso's devaluation triggered a massive wave of loan defaults. To prevent a collapse of the Mexican banking system, the government injected large amounts of capital into the banks and guaranteed all deposits. Foreign banks acquired four of the five largest banks in Mexico and controlled eighty-two percent of Mexico's banking assets by the end of 2003. Estimates for the total cost of resolving Mexico's banking crisis range between $65 billion and $104 billion.[110]

A study by Rafael La Porta and others determined that loans by Mexican banks to related parties were correlated with bank failures, were made on highly preferential terms, and performed much worse than loans to unrelated parties. The proportion of loans to related parties was substantially higher at the thirteen banks that failed as compared with the five banks that survived. In addition, loans to related parties were made on terms that were substantially less favorable to the banks, in comparison with loans made to non-affiliates. The study concluded that "[t]he case of Mexico in the 1990s suggests that the risk that related lending may lead to looting is great when banks are controlled by industrial firms, outside lending has relatively low rates of return, and

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[109] Wilmarth, supra note 1, at 1603-05.
[110] *Id.* at 1605-06.

corporate governance is weak."[111] In sum, the Mexican financial crisis of 1994-95 – like the Japanese and Korean crises – creates serious doubts about the wisdom of permitting joint control of banks and commercial firms.[112]

c. Risks of Contagion from Commercial Owners to ILCs

A further risk confronting a commercially-owned ILC is that its parent company may encounter serious problems that cause the public to lose confidence in the ILC itself. For example, when Beverly Hills Bancorp (BHB) defaulted on $13 million of commercial paper in 1973, the default destroyed public confidence in BHB's subsidiary, Beverly Hills National Bank (BHNB). BHB had used the proceeds of the commercial paper to make loans to a real estate developer. When the developer defaulted on the loans, BHB could not pay off the commercial paper. In announcing its default, BHB assured the public that its own problems would not impair the safety and soundness of BHNB. BHNB's primary regulator, the Comptroller of the Currency, also publicly stated that BHNB was "in solvent condition with satisfactory liquidity."[113] Nevertheless, depositors soon launched "large-scale runs" against BHNB, and BHNB was sued by customers who had purchased BHB's commercial paper. To prevent BHNB's failure,

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[111] Rafael La Porta et al., "Related Lending," 118 *Quarterly Journal of Economics* 231, 252-62 (2003) (quote at 262).

[112] Foreign banking crises in the 1930s similarly indicate that ownership links between banking and commercial firms create a higher risk of systemic financial crises. During the 1930s, nations with prominent universal banks (e.g., Austria, Belgium, France, Italy and Germany) experienced severe banking crises because their banks were weakened by close ownership and lending connections to troubled industries. In contrast, Canada and the United Kingdom – whose banks were barred from securities underwriting and dealing and could not own equity interests in commercial firms – did not experience a significant banking crisis during the 1930s. *See* Wilmarth, supra note 1 at 1606 n.383.

[113] Douglas W. Cray, Bancorp on Coast Reveals Problems, N. Y. Times, Dec. 31, 1973, at 27 (quoting Comptroller of the Currency James E. Smith).

regulators arranged a sale of BHNB's assets to Wells Fargo Bank in January 1974. BHNB was thereafter liquidated.[114]

Similarly, when Drexel Burnham declared bankruptcy in February 1990, following the collapse of the junk bond market, its problems quickly spread to two of its subsidiaries, which were securities broker-dealers regulated by the SEC. The regulated subsidiaries were solvent at the time of Drexel Burnham's failure, but the SEC was soon obliged to liquidate them after they could not obtain even short-term credit from counterparties or banks.[115] The contagion resulting from the failures of BHB and Drexel Burnham indicates that investors, depositors and other creditors do not believe that a regulated financial institution can be effectively shielded from serious problems occurring at its parent company.

Problems at U.S. automobile manufacturers have repeatedly caused credit ratings agencies to cut their ratings for the manufacturers' captive finance subsidiaries. During 1991-92, credit ratings agencies reduced the ratings of Chrysler Financial Corp. (CFC) to junk bond level and thereby cut off CFC's ability to issue commercial paper, because of serious financial and operational problems at its CFC's parent, Chrysler Corporation. Similarly, in recent years Ford Motor Credit Co. (FMCC) lost its investment-grade rating and was downgraded to junk bond status because of doubts among ratings agencies about the long-term viability of FMCC's parent, Ford Motor Co. (Ford). General Motors Acceptance Corp. (GMAC), the finance subsidiary of General Motors Corp. (GM), also

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[114] Wilmarth, supra note 1, at 1607.

[115] *See* William S. Haraf, "The Collapse of Drexel Burnham Lambert: Lessons for the Bank Regulators," *Regulation*, Winter 1991, at 22, 23-24; Wilmarth, "Transformation," supra note 66, at 327-38, 356 n.591, 412, 446 n.1029. *See also* Brown, supra note 79, at 23 (quoting SEC chairman Richard Breeden's testimony before a Senate committee, in which he stated that Drexel Burnham's insolvency "appears to have shattered the trust and confidence of the dealer and banking community in the subsidiary broker-dealer, even though it remained solvent with considerable excess liquid assets").

saw its credit ratings fall to junk bond levels because of the ratings agencies' concerns about GM's severe challenges.[116]

In 2006, GM agreed to sell a majority stake in GMAC to an outside investor group for $14 billion. GM needed the sale proceeds to help finance its restructuring program, and GM also hoped that its sale of control of GMAC would improve GMAC's chances of regaining its investment-grade status. GMAC had acquired a Utah-chartered ILC in 2004, and GM therefore applied to the FDIC for permission to transfer control of the ILC to GMAC's new majority owner. In November 2006, despite the FDIC's moratorium covering ILC applications, the FDIC approved GM's application.[117] In explaining its decision to exempt GM's application from the moratorium, the FDIC stated that "waiting to act until after the expiration of the moratorium could have had a significant adverse effect on GM's restructuring and GM's subsidiaries."[118] The FDIC's approval indicated that the agency felt obliged to make an exception due to "unique circumstances" involving a large and troubled commercial parent company.[119]

It is not inconceivable that Wal-Mart and Home Depot could someday find themselves in positions similar to GM and Ford. The growth rate for Wal-Mart's domestic sales has declined sharply in recent years, because (i) Wal-Mart's superstores have reached a saturation point in its traditional rural markets, and (ii) Wal-Mart has encountered significant opposition as it has attempted to build superstores in metropolitan markets. Since 2005 Wal-Mart's sales have grown at a much slower rate than the sales of

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[116] Wilmarth, supra note 1, at 1607-08.
[117] *Id.* at 1608-09.
[118] Fed. Deposit Ins. Corp., Press Release, "FDIC Board Approves Change in Control Notice for GMAC Automotive Bank, Midvale, Utah" (available at www.fdic/gov/news/news/press/2006/pr06103.html), at 2.
[119] *See id.* at 1 (stating that "[t]he FDIC acted on this change of control notice prior to the expiration of the [ILC] moratorium because of the unique circumstances of this case").

Target, its main rival. Wal-Mart has tried to offset its slowing growth in domestic markets by aggressively expanding its operations in foreign markets. However, Wal-Mart's international efforts have met with mixed success. While Wal-Mart has profitable operations in Brazil, Canada, Mexico and the United Kingdom, it withdrew from Germany and South Korea in 2006, after suffering heavy losses.[120] Wal-Mart has made its biggest overseas push in China, where it has acquired a substantial chain of retail stores. In addition, about seventy percent of the products Wal-Mart sells are produced in China. Because of its increasing dependence on China, Wal-Mart is exposed to substantial risk from either a significant upward revaluation of the Chinese yuan or a major disruption in the Chinese economy.[121]

Home Depot's results in 2006 were even more disappointing than Wal-Mart's. Home Depot's annual net profit declined in 2006 for the first time in the company's history. Like Wal-Mart, the growth of Home Depot's sales has slowed considerably as its rapid expansion during the prior two decades has apparently reached a saturation point. In addition, Home Depot pursued an ill-conceived cost reduction program that replaced skilled, full-time employees with inexperienced, part-time workers. The resulting decline in service quality alienated many of Home Depot's customers, who migrated to Lowe's (Home Depot's principal competitor). As a result of these setbacks, the chairman of Home Depot was forced to step down at the beginning of 2007.[122]

The recent problems experienced by Wal-Mart and Home Depot – like the much greater difficulties confronting GM and Ford – demonstrate that no manufacturer or

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[120] Wilmarth, supra note 1, at 1609-10; Gary McWilliams, "Wal-Mart Era Wanes Amid Big Shifts in Retail," *Wall Street Journal*, Oct. 3, 2007, at A1.
[121] Wilmarth, supra note 1, at 1610.
[122] *Id.*

retailer is “too big” to be immune from the threat of failure in a globalized and highly competitive economy. Two of the largest U.S. retailers – Kmart and Montgomery Ward – filed for bankruptcy during the domestic economy’s most recent downturn during 2000-02.[123] Similarly, Sears failed in its efforts to build a “financial supermarket” during the 1980s. Sears acquired a thrift institution (Sears Savings Bank), an insurance company (Allstate), a securities broker (Dean Witter), a credit card company (Discover), and a real estate broker and mortgage banker (Coldwell Banker). However, Sears sold or spun off all those units by the early 1990s after they failed to produce the profits and synergies Sears anticipated. Subsequently, Sears sold a large credit card business that it built up during the 1990s, after that unit generated high rates of delinquencies and charge-offs. A major reason for the credit card unit’s problems was that Sears aggressively expanded credit lines and eased credit terms to encourage cardholders to buy more products from Sears. Sears’ problems with its credit card unit provide further evidence of the potential dangers of allowing commercial firms to use ILCs as sources of credit to finance their product sales.[124]

The highly coordinated marketing strategies of today’s conglomerates are yet another factor that increases the risk of contagion within holding companies. Large financial conglomerates and their commercial rivals have emphasized the importance of a unified brand as a key strategy to promote their efforts to cross-sell a variety of products to their customers. Several of the commercial firms that have already acquired ILCs – e.g., BMW, Target, Toyota and Volkswagen – have applied the parent’s brand name to the ILC. Similarly, Wal-Mart intended to use the name “Wal-Mart Bank” for its

[123] *Id.* at 1610-11.
[124] *Id.* at 1611-12.

proposed ILC. Common brand names and cross-selling programs aggravate the risk that consumers, investors and creditors will perceive problems at commercial parent companies as direct threats to the safety and soundness of their captive ILCs.[125]

3. Does the FDIC Have Adequate Supervisory Powers to Control the Risks Created by Commercially-Owned ILCs?

The FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs. Even if Congress gave the FDIC consolidated supervisory authority over such firms, this new power would create at least four serious problems. First, the FDIC lacks the experience and expertise to identify and control the risks created by commercial affiliates of ILCs. Second, the FDIC's designation as consolidated supervisor would lead market participants to expect that the federal safety net would be available to commercial parent companies of ILCs. Third, attempts by regulators to control the activities of commercial affiliates would significantly increase the amount of governmental interference in the general economy. Fourth, large commercial owners of ILCs would be likely to enjoy substantial political influence, which they could use to extract costly subsidies or forbearance measures from legislators and regulators.

a. The FDIC's Lack of Consolidated Supervisory Authority over ILC Holding Companies

Federal law currently imposes three significant limitations on the FDIC's authority to supervise an ILC's parent holding company and the nonbank subsidiaries 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

[125] *Id.* at 1612-13.

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[."[126] 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.[127]

Second, the FDIC cannot impose capital requirements on the parent company of an ILC or on any of its nonbank subsidiaries. The FDIC has authority to establish capital requirements only with respect to state nonmember banks, including ILCs.[128] The FDIC could insist, as a condition of approving 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 maintain the ILC's status as an FDIC-insured bank.[129] However, the FDIC cannot dictate the capital structure of the parent company or its nonbank subsidiaries.[130]

Third, the FDIC has only limited authority to bring administrative enforcement proceedings (including actions for cease-and-desist orders or civil money penalties)

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[126] 12 U.S.C. § 1820(b)(4)(A). The term "affiliate" includes any company that controls, is controlled by, or is under common control with, an ILC. *Id.* §§ 1813(w)(6), 1841(k).
[127] *See* GAO-ILC Report, supra note 9, at 33-35, 38-41.
[128] 12 U.S.C. §§ 1813(q)(3), 1831*o*(c), 3902(1), 3907(a).
[129] *See* GAO-ILC Report, supra note 9, at 36-38, 41-43; *see also* 12 U.S.C. § 1816(2) (listing the "adequacy of the depository institution's capital structure" as one of seven criteria that the FDIC must consider in deciding whether to grant an application for deposit insurance). The FDIC can enforce a capital maintenance agreement by bringing administrative proceedings under 12 U.S.C. § 1818, or under the prompt corrective action provisions of 12 U.S.C. § 1831*o*.
[130] *See* GAO-ILC Report, supra note 9, at 43 (stating that "FDIC officials told us that it has never imposed capital requirements on a holding company").

against the parent company of an ILC or its nonbank subsidiaries.[131] For purposes of its enforcement authority, the FDIC can treat the ILC's parent company as an "institution-affiliatied party" (IAP), because that term includes a controlling shareholder (other than a bank holding company) of a state nonmember bank.[132] 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."[133] 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.[134] Thus, the FDIC's enforcement authority does not extend to nonbank 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.[135]

In contrast to the limited, "bank-centric" authority of the FDIC over ILCs and their affiliates, the FRB enjoys consolidated supervisory powers over bank holding companies and their nonbank subsidiaries.[136] With certain limitations, the FRB can examine a bank holding company and all of its subsidiaries,[137] and can impose capital

[131] For the FDIC's authority to bring administrative enforcement actions against state nonmember banks, *see* 12 U.S.C. §§ 1813(q)(3), 1818(b), (c), (i); McCoy, supra note 56, § 13.03.
[132] 12 U.S.C. § 1813(u)(1);
[133] *Id.* § 1813(u)(3).
[134] *Id.* §§ 1818(b)(1), (c)(1), (i)(2).
[135] *See* GAO-ILC Report, supra note 9, at 34-38, 46-47.
[136] *Id.* at 29-31 (quote on 30).
[137] *See* 12 U.S.C. § 1844(c)(2); *see also* McCoy, supra note 56, § 12.04 [1][a][ii] (explaining that, to the fullest extent possible, the FRB is required (i) to limit its examination to the bank holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of the holding company's subsidiary banks, and (ii) accept examination reports prepared by regulators of functionally regulated subsidiaries of the holding company).

requirements on the holding company and all of its nonbank subsidiaries.[138] Under the "source of strength" doctrine, the FRB may require a bank holding company to make capital contributions to a subsidiary bank or to provide other types of financial or managerial support.[139] The FRB can bring administrative enforcement proceedings against a bank holding company or any of its nonbank subsidiaries.[140] In addition, the FRB can require a bank holding company to divest any nonbank subsidiary or any nonbanking activity that presents "a serious risk to the financial safety, soundness, or stability" of one or more of the holding company's subsidiary banks.[141] By virtue of its consolidated supervisory powers, the FRB can take "a systemic approach" that encompasses the bank holding company and all of its nonbank subsidiaries, and that addresses "financial and operations risks within the holding company system that can threaten the safety and soundness of a bank subsidiary."[142]

The recent failures of two ILCs – Pacific Thrift and Loan (PTL) and Southern Pacific Bank (SPB) – show the potential dangers of relying on a bank-focused approach in supervising ILCs that are subsidiaries of holding companies. The FDIC began issuing administrative enforcement orders against PTL in 1992, but apparently the FDIC did not attempt to examine PTL's parent holding company until 1998. The FDIC discovered that the parent holding company had incurred large amounts of debt and had transferred borrowed funds to PTL, thereby enabling PTL to keep making high-risk loans that

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138 *See* 12 U.S.C. §§ 1813(q)(2)(F), 1831*o*(c), 3902(1)(A), 3907; 12 C.F.R. Part 225, App. A-E (setting forth the FRB's capital requirements for bank holding companies). *But see* 12 U.S.C. § 1844(c)(3) (limiting the FRB's authority to establish capital requirements for functionally regulated subsidiaries of bank holding companies).

139 The FRB's "source of "strength" doctrine, which is set forth in 12 C.F.R. § 225.4(a)(1), was implicitly endorsed by Congress in GLBA. *See* McCoy, supra note 56, § 4.05, at 4-53 through 4-55; GAO-ILC Report, supra note 9, at 32.

140 *See* 12 U.S.C. §§ 1813(q)(2)(F), 1818(b), (c), (i)

141 *Id.* § 1844(e)(1)

142 GAO-ILC Report, supra note 9, at 30, 40.

ultimately caused PTL's failure .in November 1999. Similarly, the FDIC began taking enforcement actions against SPB in September 1996, but did not make an on-site visit to SPB's parent holding company until February 2001. The FDIC discovered that the parent holding company had itself been experiencing significant losses since 1998 and could not provide sufficient capital support to prevent SPB from failing in February 2003.[143] The failures of PTL and SPB indicate that

> the bank-centric approach alone is not sufficient to assess all the risks that a holding company and affiliates can pose to an insured financial institution. . . . [In contrast,] consolidated supervision provides [the FRB's] examiners with both the ability to understand the financial strength and risks of the overall [bank] holding company . . . and the authority to address significant management, operations, capital, and other deficiencies throughout the organization before these deficiencies pose a danger to affiliate insured banks and the bank insurance fund.[144]

Similarly, the SEC acknowledged after the collapse of Drexel Burnham in 1990 that it "did not have adequate information regarding the Drexel holding company and its unregulated affiliates."[145] The lack of such information "severely hindered" the SEC's ability to evaluate the threat posed to Drexel Burnham's broker-dealer subsidiaries, including the "ability to know of the imminence of a liquidity crisis for the parent, and the corresponding risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors."[146] In 2004, the SEC adopted a new consolidated supervisory approach, which applies on a voluntary basis to

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143 Wilmarth, supra note 1, at 1615-16.
144 GAO-ILC Report, supra note 9, at 61-62 (reporting views of FRB officials).
145 Brown, supra note 79, at 25 (quoting testimony of SEC chairman Richard Breeden).
146 *Id.* (same).

"supervised investment bank holding companies" (SIBHCs) that own securities broker-dealers.[147]

In February 2007, the FDIC expressed its concern that "the current supervisory process and infrastructure [for ILCs] may not produce the safeguards that the FDIC believes could be helpful" in evaluating and controlling the risks presented by ILC holding companies that are not subject to consolidated supervision by either the FRB or the OTS.[148] The FDIC therefore issued a proposed regulation, which would apply to any holding company that (i) is engaged solely in financial activities, (ii) proposes to acquire control of an ILC, and (iii) would not be subject to consolidated supervision by the FRB or the OTS. The FDIC's proposed regulation would require such a holding company to enter into a written agreement with the FDIC as a condition for acquiring control of the ILC. The agreement would require the parent holding company to (i) provide information and reports to the FDIC concerning the operations of itself and its nonbank subsidiaries, (ii) allow the FDIC to examine the holding company and each of its subsidiaries, and (iii) maintain the ILC's capital at specified levels.[149]

It is not entirely clear whether the FDIC has authority to force companies that acquire ILCs to enter into the consolidated supervision agreement described in the FDIC's proposed regulation.[150] However, the proposed regulation does make clear that the FDIC is no longer comfortable in providing deposit insurance to ILCs whose parent companies are not subject to consolidated supervision by a federal banking agency.

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[147] Wilmarth, supra note 1, at 1616 & n. 439 (stating that holding companies that own securities broker-dealers can voluntarily register with the SEC as SIBHCs in order to satisfy the requirements of the European Union's Conglomerates Directive).
[148] FDIC Moratorium Extension Notice, supra note 2, at 5293.
[149] FDIC Proposed Rule on Consolidated Supervision, supra note 17, at 5222-27.
[150] *Compare id.* at 5223 (contending that the FDIC possesses authority to adopt the proposed regulation) *with* GAO-ILC Report, supra note 9, at 45-46 (indicating some doubt whether the FDIC has authority to impose consolidated supervisory requirements on applicants who seek to acquire ILCs).

b. Providing the FDIC with Consolidated Supervisory Authority over Commercial Parent Companies of ILCs Would Have Adverse Consequences

The problems arising out of acquisitions of ILCs by commercial firms cannot be solved simply by establishing the FDIC as the consolidated supervisor of such firms. To the contrary, the designation 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.[151]

Second, the FDIC's designation 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 could lead market participants to expect that the federal safety net would potentially be available to commercial parent companies of ILCs.[152]

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 directing the relationships between main banks and their commercial clients. Government regulators frequently

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[151] *See, e.g.,* Brown, supra note 79, at 4, 24-25, 42-45, 47; Statement by E. Gerald Corrigan, President, Federal Reserve Bank of New York, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, April 11, 1991, reprinted in 77 Fed. Res. Bull. 411, 418-19 (1991).

[152] Statement by E. Gerald Corrigan, supra note 151, at 418-20.

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 weaken the market-driven dynamics of the U.S. economy.[153]

Federal law currently requires the FDIC to oversee every transaction that results in the transfer of control of an ILC's parent company. As shown by GM's recent sale of control of its subsidiary ILC, the Change in Bank Control Act (CBCA)[154] requires the FDIC to review, and to decide whether to disapprove, any proposed change in control of a state nonmember bank.[155] The CBCA provides a significant impediment to any hostile takeover of a parent company of an ILC,[156] and the CBCA therefore undermines the effectiveness of the takeover market in disciplining managers of such companies.

Fourth, major commercial firms that acquire ILCs are likely to use political influence to obtain subsidies or forbearance from regulators. Big commercial firms that own ILCs are likely to be not only TBTF but also "too big to discipline adequately" (TBTDA).[157] Major banks have proven to be TBTDA in the past. For example, during the banking crisis of 1984-92, Bank of America and Citicorp, the two largest U.S. banks, each came perilously close to failure. However, federal regulators did not take any public enforcement actions against the banks or insist upon a replacement of their managers. Instead, regulators quietly entered into nonpublic "memoranda of understanding," the

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153 Wilmarth, supra note 1, at 1599-1603, 1618; Statement by E. Gerald Corrigan, supra note 151, at 419.
154 12 U.S.C. § 1817(j).
155 *See* McCoy, supra note 56, § 10.02[1][a]; supra notes 117-19 and accompanying text (discussing the FDIC"s approval of GM's sale of control of its ILC).
156 *See* Wilmarth, "Transformation," supra note 66, at 291-92 (explaining that hostile takeovers of banks rarely occur, because "[r]egulatory approval requirements for bank mergers create significant obstacles to hostile takeovers").
157 TBTDA is a term coined by Professor Edward J. Kane. *See* Kane, Megamerger Incentives, supra note 65, at 673.

weakest form of enforcement action, with both banks. 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 loss of public confidence in the banking system.[158]

The FDIC's decision in November 2006 to waive its initial ILC moratorium, and to approve GM's sale of control of GMAC and its ILC subsidiary, is suggestive of the type of regulatory forbearance that is likely to be extended to large commercial owners of ILCs. The FDIC's decision was criticized by a well-known bank analyst, who "accused the FDIC of bowing to congressional pressure and showing preferential treatment to certain companies."[159] The FDIC may well have adopted a "pragmatic approach" in removing an obstacle to a transaction that was viewed as "critical to the health of General Motors."[160] However, the FDIC's decision clearly indicates that major companies owning ILCs will receive special consideration from regulators if their financial stability is important to the national economy.

Conclusion

The FDIC made the right decision when it imposed a moratorium on further acquisitions of ILCs by commercial firms so that Congress could consider the need for legislation barring such acquisitions. As shown above, commercial ownership of ILCs conflicts with our policy of separating banking and commerce. In addition, commercially-owned ILCs present significant risks to our financial system and our national economy. Commercial ownership of ILCs is likely to create serious distortions

[158] Wilmarth, "Transformation," supra note 66, at 304-06.
[159] Joe Adler, "Approval for GM ILC Deal Pleases Industry," *American Banker*, Nov. 17, 2006, at 4 (reporting on statement by analyst Richard X. Bove).
[160] *Id.* (quoting Rep. Gillmor).

and competitive imbalances in our economy by (i) extending TBTF protection to large commercial owners of ILCs and (ii) encouraging ILCs to use their federally-subsidized, low-cost deposits to fund loans that will benefit their parent company's operations. Consolidated supervision of commercially-owned ILCs cannot control these risks and is likely to have additional negative effects. Consolidated supervision would increase the likelihood of TBTF bailouts, because FDIC supervision would cause the market to expect that the federal safety net would be available to commercial owners of ILCs. Moreover, consolidated supervision would require the FDIC to monitor and evaluate the operations of all commercial affiliates of ILCs, thereby producing an even more intrusive federal regulatory presence in the general economy.

Congress should therefore enact legislation to prohibit further acquisitions of ILCs by commercial firms. At present, there are only fifteen such firms, and their number should not be allowed to increase. On four occasions during the past half century – in 1956, 1970, 1987 and 1999 – Congress acted to prevent widespread ownership of FDIC-insured depository institutions by commercial firms. It is time for Congress to do the same thing with respect to ILCs.