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I. INTRODUCTION

IN the fall of 2008, the United States experienced an unprecedented financial collapse that has dramatically affected global financial markets and called into question banking practices and regulations previously thought to be sound. Politicians and economists have cobbled together remedies to restore confidence in a banking system and regulatory framework that have not been updated since the Great Depression. As the nature of banks, banking, and finance have changed drastically in the last several decades, appropriate and effective remedies to the current financial crisis are difficult without revisions to outdated theories and regulations governing the financial system. One such theory is that banking and commerce should not mix.[1] This theory was born after the Great Depression because of fears of conglomeration and abuse and enforced through several decades of regulation.[2] However, the conglomerated nature of banking today renders these fears moot.

Though the financial systems of several other countries have benefited from mixing banking and commerce,[3] the United States has minimally tested this principle in just one area—the Industrial Loan Company (ILC) banking charter. The ILC, which is the only banking charter that a commercial firm can operate and is authorized by only a few states, came under intense scrutiny in 2005 when Wal-Mart applied for an ILC charter

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1. Throughout this article, I will use the term "banking" to mean a commercial bank that accepts deposits and makes loans—the traditional definition of bank. Investment banking differs from traditional banking due to activities such as securities underwriting and brokerage arms. The term "commerce" refers to non-financial firms, such as retail or industrial firms whose primary business is not financial. The "mixing of banking and commerce" is when banking and commercial firms are affiliated, have common ownership, or when either commercial firms conduct banking activities or vice versa. This article will deal primarily with bank ownership structure and not with the types of activities that can be conducted within a bank. For a review of the debate about the mixing of commerce and banking, see Thomas F. Huertas, *Can Banking and Commerce Mix?*, 7 CATO J. 743, 743–62 (1988).

2. *See infra* Part III.B.2 and accompanying notes.

3. *See* Joseph G. Haubrich & João A.C. Santos, *Alternative Forms of Mixing Banking with Commerce: Evidence from American History*, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 121, 123 & 159–60 (2003).

and attempted to enter the banking industry.[4] The commotion surrounding the ILC died down shortly after Wal-Mart withdrew its application in 2007, but skepticism of its value and soundness continues to remain high among some lawmakers and regulators.[5] However, as the recent financial crisis has caused many U.S. banks to falter or fail, ILCs have remained sound mainly due to their stable commercial alliances.[6] In over two decades of operation, no commercially owned ILC has caused any loss to the FDIC fund, largely as a result of efficient regulation and its reliance on parent commercial firms.[7] As the traditional banking framework falters, the resilient structure and success of the ILC, once a banking outcast, should serve as a prototype of an emerging banking model and a provider of much needed stability.

The ILC structure has been both maligned and ignored by policymakers, and treated as a deviant and problematic banking structure. Recently, the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank bill) issued a moratorium on new charters and cast doubt on their continued existence.[8] The ILC structure and its ramifications to the modern state of banking have not been adequately studied in academic or public discourse. It is especially important to examine the ILC in the aftermath of a banking collapse that has crippled the nation.

Part II of this paper documents the background of ILCs and the current debate on ILCs, beginning with Wal-Mart's infamous application in 2005, Congress's attempts to suspend ILCs in 2007, and the current banking proposals addressing the ILC charter. Part III sets forth the arguments waged against the ILC and challenges the idea that a separation of commerce and banking is necessary for financial stability. Part IV identifies the utility and strength of the ILC and the broader economic advantages of mixing commerce and banking.

II. INDUSTRIAL LOAN COMPANIES

Industrial loan companies and industrial banks are FDIC-insured, state-chartered banks that are unique among banks in that commercial firms can own them.[9] ILCs are similar to commercial banks in the activities they are able to conduct, their management, and their regulatory structure.[10] Under current law, a commercial company, such as Wal-Mart

4. *See infra* Part II.C and accompanying notes.

5. *See* Cheyenne Hopkins & Joe Adler, *Thrift Charter and ILC Option Won't Go Down Without a Fight*, AM. BANKER, June 17, 2009, at 1.

6. *See infra* notes 288–93 and accompanying text.

7. *See infra* note 264 and accompanying text.

8. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 12 U.S.C. § 1815).

9. *See* Mindy West, *The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective*, SUPERVISORY INSIGHTS, Summer 2004, at 5, *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisum04.pdf.

10. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-621, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY (2005) [hereinafter GAO REPORT].

or Ford Motor Company (Ford), cannot own a retail bank.[11] With an ILC charter, however, a commercial company can own an "industrial bank,"[12] which in practice has most of the powers of retail banks, including deposit-taking and lending. Industrial banks are chartered under an exception to the federal Bank Holding Company Act (BHC Act), which allows commercial companies to own industrial banks without the restrictions that generally apply to Bank Holding Companies (BHCs). This exception also allows these commercial companies to own these banks without being subject to federal consolidated bank supervision.[13]

Only seven states have chartered industrial banks in the past: Utah, Nevada, California, Hawaii, Colorado, Minnesota, and Indiana.[14] However, most of these no longer permit the chartering of ILCs or do not have a system in place to regulate them.[15] Utah has become the home of ILCs and has chartered and regulated virtually all ILCs established in the last two decades.[16] ILCs are state-chartered banks and "state nonmember banks," and their primary federal banking supervisor is the FDIC, pursuant to the Federal Deposit Insurance Act (FDI Act).[17] The FDIC regulates ILCs with the same authority and procedure it uses to supervise other banks.[18]

Ironically, opposition to the ILC stemmed from its popularity rather than from any inherent problem in the industry.[19] At their inception,

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11. The Bank Holding Company Act states that a company that controls a bank must not engage in non-banking activities. 12 U.S.C. § 1843(a) (2006).

12. Utah law was amended in 2004 and now refers to ILCs as industrial banks. UTAH CODE ANN. § 7-8-21 (West 2009). This article will refer to this entity as the "ILC" as the term is more widely used among legislators and commentators.

13. *See* Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5227 (Feb. 5, 2007) (to be codified at 12 C.F.R. pt. 354) (notice). By using the term "Federal Consolidated Bank Supervision," I refer to the supervision provided by either the Federal Reserve Board or the Office of Thrift Supervision. The Gramm–Leach–Bliley Act (GLB) of 1999 gives the Federal Reserve supervision over BHCs and Financial Holding Companies (FHC's). Pub. L. No. 106-102, tit. I, 113 Stat. 1338, 1370 (1999). A firm that is a holding company for a non-BHC Act bank is not a BHC and is not subject to Federal Consolidated Bank Supervision. 12 U.S.C. § 1813(a)(2) (2006).

14. *See Industrial Loan Companies: A Review of Charter, Ownership, and Supervision Issues Before the H. Comm. on Fin. Servs.*, 109th Cong. 19 (2006) (statement of Douglas H. Jones, Acting General Counsel, FDIC) [hereinafter Jones Statement]; H.R. REP. NO. 110-155, at 9 (2007).

15. Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. at 522 n.33; *see also* H.R. REP. NO. 110-155, *supra* note 14, at 10. *See generally* GAO REPORT, *supra* note 10.

16. George Sutton, *Industrial Banks*, 56 CONSUMER FIN. L.Q. REP. 178, 179 (2002); *see* GAO REPORT, *supra* note 10, at 16.

17. West, *supra* note 9, at 5.

18. Jones Statement, *supra* note 14, at 9.

19. In his address to Congress as they were deliberating the suspension of the ILC charter, Utah Commissioner Edward Leary stated:

> I believe that I am here today because of the success of th[e] regulatory model, not its failure. . . . I am told the articulated threat which warrants passage of this bill is a potential threat of misuse of the charter by holding companies which are non-financially oriented. This bill seeks to remove a potential threat even before the threat materialized or manifests itself.

industrial banks focused on small consumer loans in local markets.[20] Today, many large international companies control industrial banks and use them to support their complex business transactions and financial operations.[21] In the last decade, ILCs experienced an exponential growth of assets and deposits held.[22] Proponents of the ILC feel that the expansion of the ILC model is indicative of its success and of the market need for such entities.[23] Opponents of the charter, a group that emerged to oppose Wal-Mart's proposed ILC a few years ago,[24] claim that the mixing of banking and commerce, uniquely allowed through the ILC charter, increases systemic risk to the financial system[25] and can lead to harmful concentrations of power.[26] In Part III, I will address each of these arguments and several others, and I will propose that they are largely without merit and are not supported by history or empirical studies. In Part IV, I discuss the advantages of mixing banking and commerce and demonstrate that the ILC should not be suspended, but rather used as a model to shape future banking regulation.

A. HISTORY OF ILC FORMATION

Historically, ILCs were state-chartered banks organized to give loans to industrial workers who were not being served by other creditors.[27] Arthur Morris established the first ILC in 1910, and it operated much like a finance company.[28] These early ILCs were not permitted by law to accept "deposits" but, instead, could issue something similar to a deposit called a "thrift certificate" to avoid the term.[29] A crucial difference was that these thrift certificates were not eligible for FDIC deposit insurance.[30]

The Industrial Bank Holding Company Act of 2007: Hearing on H.R. 698 Before the H. Comm. on Financial Servs., 110th Cong. 17 (2007) (testimony of G. Edward Leary, Utah Comm'r of Fin. Institutions) [hereinafter Leary Testimony].

20. Christian Johnson & George G. Kaufman, *A Bank By Any Other Name . . .*, 31 ECON. PERSP. (Fed Res. of Bank of Chi., Chi., Ill.), Fourth Quarter 2007, at 37, 41 *available at* http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2007/ep_4qtr2007_part3_johnson_etal.pdf.

21. *See id.* at 42; GAO REPORT, *supra* note 10, at 16.

22. *See* GAO REPORT, *supra* note 10, at 16.

23. *See generally ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 51–52 (2006) (testimony of George Sutton on behalf of the Securities Industry Association) [hereinafter Sutton Testimony].

24. *See* H. COMM. ON FIN. SERVS., AT ISSUE: RETAILERS PURCHASING INDUSTRIAL LOAN COMPANIES (ILCs) (May 2, 2007), *available at* http://financialservices.house.gov/RetailersInBanking.html.

25. *See* GAO REPORT, *supra* note 10, at 29–30; Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1588 (2007)

26. *See* Letter from Alan Greenspan, Chairman of the Bd. of Governors of the Fed. Res. Sys., to Tim Johnson, U.S. Sen. (June 25, 2003), 2003 Fed. Res. Super. Ltrs. LEXIS 17; *see also* GAO REPORT, *supra* note 10, at 18–21. *See generally* Wilmarth, *supra* note 25.

27. *See* West, *supra* note 9, at 8.

28. *See id.* at 7.

29. *Id.* at 8.

30. *See id.*

In 1982, the ILC industry changed dramatically when the Garn-St. Germain Depository Institutions Act (Garn-St. Germain Act) formally acknowledged thrift certificates and made them eligible for federal deposit insurance.[31] Some states, including Utah and California, responded by requiring ILCs to obtain FDIC insurance in order to keep their charters.[32] As a condition to receiving FDIC insurance, many ILCs were required to increase credit quality and meet other measures of general bank soundness.[33] After ILCs received FDIC insurance, demand for the charter increased.[34]

In the mid-1980s, ILCs and other "non-bank" charters, which functioned as banks but were not subject to the BHC Act, became popular[35] because they allowed their parent corporations to engage in "non-banking" activities.[36] Congress responded in 1987 with the Competitive Equality Banking Act (CEBA), which brought many of these non-banks under the umbrella of the BHC Act.[37] CEBA declared that all banks insured by the FDIC were "banks" and thus subject to the BHC Act and all of its activity restrictions,[38] which forced them to cease any non-banking activity.[39] However, CEBA provided a specific exception for ILCs, making ILCs one of the only non-bank alternatives available for commercial firms.[40] Thus, pursuant to CEBA, an ILC is not a "bank" for purposes of the BHC Act if it meets one of the following conditions: (1) the institution "does not accept demand deposits," (2) the institution's total assets are less than $100,000,000, or (3) no company has acquired control of the institution after August 10, 1987.[41]

It was CEBA's ILC exception that caused the boom in the ILC industry because CEBA made the ILC the only available banking option for commercial firms.[42] The first application for a commercially owned ILC

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31. *Id.* at 8; *see* Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469.

32. *See* West, *supra* note 9, at 8.

33. *See id.*

34. *See id.* at 9.

35. *Id.* According to the definition of "bank" under the BHC Act, a bank had to both make loans and accept deposits. By only engaging in one of these tasks, an entity could fall outside the BHC Act's definition and therefore avoid being subject to the Act. These entities became known as "non-bank banks" and were still eligible for FDIC insurance. *Id.* at 9 n.10.

36. *Id.* at 9.

37. *See id.*; Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101, 101 Stat. 552, 554 (defining banks as institutions insured by the FDIC or that accept demand deposits and make commercial loans).

38. 12 U.S.C. § 1841(c)(A) (2006) (defining "bank" under the BHC Act); 12 U.S.C. § 1813(h) (2006) (defining "insured bank").

39. The BHC Act states that a company controls another if it (1) has direct or indirect ownership, control, or power to vote 25% or more of any class of voting securities of that company; (2) is able in any manner to elect a majority of the directors of that company; or (3) is able to exercise, directly or indirectly, a controlling influence over that company as determined by the Board. 12 U.S.C. § 1841(a)(2).

40. *Id.* § 1841(c)(2)(H).

41. *Id.* § 1813(a)(2).

42. *See* West, *supra* note 9, at 9. *See generally* O. Emre Ergungor & James B. Thomson, *Industrial Loan Companies*, ECON. COMMENT. (Federal Bank of Cleveland, Cleve-

was filed with the FDIC in 1988, and many others followed.[43] The industry grew rapidly and without controversy until Wal-Mart applied for an ILC charter.[44] In response to Wal-Mart's application, the Government Accountability Office (GAO) expressed concerns about industrial banks[45] and questioned, among other things, whether the FDIC's supervisory authority was sufficient to protect industrial banks.[46] However, the extensive GAO report did not reveal any inherent risks in the ILC industry.[47] Lawrence J. White, an NYU professor and former member of the Federal Home Loan Bank Board (FHLBB), stated in his prepared testimony for Congressional hearings on July 12, 2006, that "[i]t is surely no secret that the event that has drawn such extensive public attention to the existence of ILC charters has been Wal-Mart's application to obtain a Utah ILC charter and FDIC deposit insurance for its ILC."[48] He referred to Wal-Mart's application as the "900 pound gorilla in the room."[49] Notably, Target, Nordstrom, and many other large commercial firms obtained federal deposit insurance without any controversy prior to Wal-Mart's application.[50]

B. THE GROWTH OF THE ILC

The ILC industry experienced dramatic growth for two decades.[51] Between 1987 and 2007, industrial bank total assets grew from $4.2 billion to over $243 billion.[52] The growth resulted largely from non-BHC financial firms opening ILCs to serve their banking needs and several commercial firms using ILCs to service their various consumer needs.[53] By far, Utah saw the largest increase in ILC assets during this period and increased its

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land, Ohio), Oct. 1, 2006, *available at* http://www.clevelandfed.org/research/Commentary/2006/1001.pdf.

43. *See* West, *supra* note 9, at 9.

44. *See* Alexander Raskovich, *Should Banking Be Kept Separate from Commerce* 1 (U.S. Dep't of Justice, Econ. Analysis Grp., EAG 08-8, 2008), http://www.justice.gov/atr/public/eag/236665.pdf.

45. *See generally* GAO REPORT, *supra* note 10.

46. *See id.* at 21.

47. *See* GAO REPORT, *supra* note 10, at 9–10.

48. *ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 218 (2006) (testimony of Lawrence J. White) [hereinafter White Testimony].

49. *Id.*

50. Liz Pulliam Weston, *National Bank of Wal-Mart?*, MSN MONEY, http://moneycentral.msn.com/content/Banking/Betterbanking/P109171.asp (last visited Aug. 2, 2010).

51. *Industrial Bank Holding Company Act of 2007: Hearing on H.R. 698 Before the H. Comm. on Fin. Servs.*,110th Cong. 126 (2007) (statement of Donald L. Kohn, Vice Chairman, Bd. of Governors of the Fed. Res. Sys.) [hereinafter Kohn Testimony]; *see also* GAO REPORT, *supra* note 10, at 16.

52. *See* Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5218 (Feb. 5, 2007) (to be codified at 12 C.F.R. pt. 354) (notice); John Daley, *Utah's industrial banks appear "Safe and Sound,"* KSL (Sep. 16, 2008, 5:00 PM), http://www.ksl.com/?nid=1488sid=4280214.

53. Of the twenty-seven ILCs operating in Utah today, eight are considered to have a commercial parent company. *See* G. Edward Leary, Utah Comm'r of Fin. Institutions, Remarks before Utah Ass'n of Fin. Servs. 3 (Aug. 25, 2006) (transcript *available at* http://www.dfi.utah.gov/PDFiles/IB%20Speech%202006.pdf) [hereinafter Leary Remarks].

market share of ILC assets from 11% to 82%.[54]

Many ILC opponents expressed concern about this dramatic growth because they perceived the ILC industry to be growing at a threatening rate.[55] However, at its height, the entire ILC industry was only about 1.5% of the banking industry.[56] The growth of the ILC, however, was and is indicative of its increased popularity for large commercial and financial firms.[57] ILCs were growing because they provided the only way for their commercial parents to participate in certain financing activities that they viewed as cost-effective and complimentary to the marketing of their other products.[58]

However, that growth has been halted by the recent financial crisis, which has caused many investment banks and credit card companies to seek BHC status and convert their ILCs into state-chartered banks.[59] This change has caused a contraction in the ILC sector, which has shrunk from a high of $243 billion in assets in June 2008 to $104 billion in September 2009.[60] The continued growth of ILCs is uncertain, as their future depends on whether and how policymakers decide to change the industry.[61] Most of the large investment banks that formerly dominated the ILC world applied for BHC status to gain access to Troubled Asset Relief Program (TARP) funds and the Federal Reserve's discount window, but also, and perhaps more importantly, to increase investor confidence.[62]

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54. *See* GAO REPORT, *supra* note 10, at 19–20. Most ILCs have been established in Utah because the state is perceived as "business-friendly" to ILCs and Utah's usury laws are more desirable for the ILC business. *Id.* at 16, 19.

55. *See* GAO REPORT, *supra* note 10, at 16.

56. Leary Remarks, *supra* note 53, at 2; *see ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 22 (2006) (testimony of G. Edward Leary, Utah Comm'r of Fin. Institutions), *available at* http://financialservices.house.gov/media/pdf/071206gel.pdf; *see also* FED. RES. BD., REP. ON THE CONDITION OF THE U.S. BANKING INDUSTRY: THIRD QUARTER, 2005 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/bank_condition/default.htm.

57. Kenneth Spong & Eric Robbins, *Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate*, ECON. REV. (Federal Bank of Kansas City, Kansas City, Missouri), Fourth Quarter 2007, at 41, 43, http://www.kansascityfed.org/PUBLICAT/ECONREV/PDF/4q07Spong.pdf.

58. *Id.*

59. Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era*, N.Y. TIMES, Sept. 21, 2008, at A1. In order to comply with the BHC, many of these firms will convert their ILCs into state-chartered banks. GMAC has already converted its ILC to a Utah-chartered state bank. Press Release, GMAC Fin. Servs., GMAC Financial Services Bank Holding Company Application Approved by Federal Reserve (Dec. 24, 2008), *available at* http://media.gmccfs.com/index.php?s=43&item=298. Goldman Sachs has converted its ILC into a New York state-chartered bank. *Goldman Sachs Gets N.Y. Banking License*, N.Y. TIMES, Nov. 28, 2008, at B2; Jeff Bater, *Fed Waives 5-Day Waiting Period on Goldman, Morgan Stanley*, REAL TIME ECONOMICS (Sept. 22, 2008, 12:02 PM), http://blogs.wsj.com/economics/2008/09/22/fed-waives-5-day-waiting-period-on-goldman-morgan-stanley/.

60. E-mail from Darryle Rude, Supervisor of Industrial Banks for the State of Utah, to author (Dec. 2, 2009, 15:20 MST) (on file with the SMU Law Review).

61. Jonathan Stempel, *Obama regulatory plan hits industrial loan cos*, REUTERS (June 19, 2009, 8:07 AM), http://www.reuters.com/article/idUSN1943466520090619.

62. *See generally* Sorkin & Bajaj, *supra* note 59. At least one firm that has experienced success in owning an ILC reportedly converted to a BHC in order to participate

These firms include financial giants, such as Goldman Sachs, Morgan Stanley, American Express, GMAC, and CIT, among others.[63] Because these large investment banks participate in some "commercial activities," such as merchant banking, these banks were not regulated by the Federal Reserve, were not considered BHCs, and could not own or operate banks.[64] However, these investment banks are basically "shadow banks," engaged in financial activity with similar risks and liabilities as traditional banks but with added risk due to their highly leveraged business model.[65] By becoming BHCs, the firms are agreeing to increased federal oversight and activity restrictions, such as higher capital reserves and lower risk profiles.[66]

The new wave of conversions of investment banks to BHCs has focused the ILC debate on commercial firm ownership of ILCs and highlights the need for clearer regulation addressing the separation of banking and commerce.[67] This article focuses primarily on commercial firm ownership of ILCs and not on investment banking for several reasons. First, as mentioned, most investment banks that owned ILCs have now become BHCs and are no longer dominant players in the ILC field.[68] Second, as the massive conversion of investment banks to BHCs demonstrates, there

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more fully in banking. Robert Barba, *For This REIT, Bank Status Is Worth the Tax*, AM. BANKER, Jan. 2, 2009, at 1.

63. *See generally* Sorkin & Bajaj, *supra* note 59; Press Release, GMAC Fin. Servs., *supra* note 59.

64. In 1999, the GLB Act allowed investment banks, for the first time since the Great Depression, to engage in commercial activities and "merchant banking" endeavors. *See* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 122, 113 Stat. 1338, 1381 (1999); SEN. COMM. ON BANKING, FINANCE, AND URBAN AFFAIRS, FIN. SERVS. MODERNIZATION ACT, GRAMM-LEACH-BLILEY, SUMMARY OF PROVISIONS, http://banking.senate.gov/conf/gr-mleach.htm (last visited Oct. 9, 2010).

65. *See* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 195 (2009).

66. *See* Sorkin & Bajaj, *supra* note 59. But most industry observers do not expect to see major changes to the operations of these firms and even expect that the change is temporary and that the firms will try to shed their BHC status when the market becomes more stable. Steven Sloan, *Can Even Fed Oversight Alter Investment Banking Giants?*, AM. BANKER, Feb. 2, 2009, at 1.

67. The Department of the Treasury has already released a "Blueprint" for revised regulation that deals specifically with the BHC Act. U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 164 (2008) [hereinafter TREASURY BLUEPRINT], *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf. As financial institutions increasingly become BHCs, Congress will need to decide whether it will lift some BHC Act restrictions to allow these firms to engage in commercial activity as they have done in the past or solidify the separation of commerce and banking within these large investment banks. Sloan, *supra* note 66, at 1. The Treasury has recently suggested that some of the rigid activity restrictions of the BHC Act on financial firms be lifted and that a new regulatory framework of broad federal oversight be implemented. The Treasury proposed allowing commercial firms to own banks in a blueprint aimed at revamping financial regulation in April 2008, but it is unlikely that such a plan would be approved in the near future. The Treasury Blueprint outlined a new regulatory regime that would have increased supervision of all banking affiliates. *See generally* TREASURY BLUEPRINT, *supra*. *See* Joe Adler, *Paulson Plan Would Open Charters to All Comers; Banking-Commerce Divide Would End, Fed Would Add Oversight*, AM. BANKER, Apr. 3, 2008, at 1.

68. *See generally* Sorkin & Bajaj, *supra* note 59.

is a blurry distinction between investment banking and commercial banking—often, the activities of investment banks were primarily financial in nature and, thus, not dissimilar to the activities conducted in their ILCs.[69] This article seeks to highlight the advantages of commercial ownership of banks and the advantages of a diversified ownership model in banking. An investment bank has a similar business model to a BHC, which is run similarly to a bank, and does not add diversity across sectors, as opposed to a retail or industrial owner of a bank whose business operations and vulnerabilities differ greatly from a bank and can offer balance and support to their subsidiary.[70]

This article does not address the Gramm–Leach–Bliley Act (GLB), which allowed for the mixing of banking and commerce that created these investment banking entities. The GLB allowed traditional financial institutions to engage in various commercial activities, such as securities and insurance underwriting.[71] The wisdom of this expansion has recently been challenged but is beyond the scope of this article. Although the term "separation of banking and commerce" has been used to describe restrictions on bank activities (what a bank can do) and on bank ownership structure (who can own a bank), this article only addresses the latter.

C. The Wal-Mart Application

The ILC industry operated quietly in the banking world until 2005 when Wal-Mart filed its application to open an ILC.[72] Wal-Mart intended to use an ILC to service its credit card transactions in-house to save the 2% to 3% that it paid to a third-party server.[73] However, Wal-Mart's application drew criticism from the banking industry, policymakers, and consumer groups.[74] On June 8, 2006, ninety-eight members of Congress wrote to the FDIC to request a moratorium on approvals of

69. *See* Knowledge@Wharton, *Banking Reform Proposals: Why They Miss the Mark*, Financial Times (Mar. 15, 2010), http://www.ftpress.com/articles/article.aspx?p=1567488.

70. *See* Christine E. Blair, *The Mixing of Banking and Commerce: Current Policy Issues*, 16 FDIC Banking Rev., no. 4, 2004 at 97, 101–02 (2004), *available at* http://www.fdic.gov/bank/analytical/Banking/2005;an/article3.pdf.

71. *See* Sen. Comm. on Banking, Finance, and Urban Affairs, *supra* note 64.

72. *See* Application for Deposit Insurance for Wal-Mart Bank, 71 Fed. Reg. 10,531, 10,532 (Mar. 1, 2006) (public hearing notice) [hereinafter Wal-Mart FDIC Application]; Shaheen Pasha, *Coming soon: A Wal-Mart Bank?*, CNN/Money (Oct. 27, 2005, 2:24 PM), http://money.cnn.com/2005/10/27/news/economy/walmart_banks/.

73. According to the application filed with the FDIC, the bank will provide Wal-Mart with access to the Automated Clearing House network so that they can process checks and debit card transactions. *See* Application for Deposit Insurance for Wal-Mart Bank, *supra* note 72. The application also states that Wal-Mart will be the bank's only customer and the bank will not seek out additional customers. *Id.*; *see* Pasha, *supra* note 72; *see also* David Breitkopf, *Wal-Mart's Financial Vision: In Payments; Spotlight on An ILC's Role*, Am. Banker, Oct. 5, 2005, at 1.

74. *See* Eric Dash, *Wal-Mart Abandons Bank Plans*, N.Y. Times, Mar. 17, 2007, at C1, *available at* http://www.nytimes.com/2007/03/17/business/17bank.html; *see also* Letter from Camden R. Fine, President and CEO, Indep. Cmty. Bankers of Am., to Donald E. Powell, Chairman, Fed. Deposit Ins. Corp. and John F. Carter, Reg'l Dir., Fed. Deposit Ins. Corp. 6 (Aug. 18, 2005), http://www.icba.org/files/ICBASites/PDFs/ltr081805.pdf [hereinafter ICBA Letter].

commercially owned industrial banks until Congress could consider the continued viability of the ILC charter.[75] The FDIC subsequently imposed a six-month moratorium on July 28, 2006,[76] and extended it several times before it finally expired on January 31, 2008.[77] Although the FDIC expressed the opinion that the ILC industry was sound, it issued the moratorium to pass the difficult and controversial decision of what to do with Wal-Mart's application on to Congress.[78] As the FDIC explained in a statement, "the original moratorium demonstrated that the growth of the ILC industry, the trend toward commercial company ownership of ILCs and the nature of some ILC business models have raised significant questions about the risks to the deposit insurance fund."[79] According to the FDIC, the moratorium "provide[s] Congress with an opportunity to address the issue legislatively while the FDIC considers how best to respond to any safety and soundness issues surrounding commercial ownership under existing law."[80]

To say that Wal-Mart's application was "controversial" would be an understatement. After the FDIC's moratorium, Congress received more

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75. *Banking: Representative Roscoe Bartlett*, REPRESENTATIVE ROSCOE BARTLETT http://bartlett.house.gov/Issues/Issue/?IssueID=2047 (last visited Aug. 4, 2010) [hereinafter Bartlett Statement]; *see Industrial Bank Holding Company Act of 2007: Hearing on H.R. 698 Before the H. Comm. On Financial Services*, 110th Cong. 10 (2007) (statement of Sheila C. Bair, Chairman, FDIC) [hereinafter Bair Statement].

76. Bartlett Statement, *supra* note 75. Roscoe Bartlett and "Reps. Frank and Gillmor, joined by 115 other Members of Congress, wrote to the FDIC on December 7, 2006 and requested that the moratorium be extended." Statement of Banking Representative Roscoe Bartlett. For a complete description of FDIC action since the announcement of the first moratorium, see Bair Statement, *supra* note 75, at 10.

77. *See* Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5219–20 (proposed Feb. 5, 2007) (to be codified at 12 C.F.R. pt. 354); Joe Adler, *As Moratorium Ends, Few ILC Seekers Left to Fight*, AM. BANKER, Jan. 31 2008, at 1.

78. The FDIC testified that there are no inherent problems in the ILC charter. Bair Statement, *supra* note 75, at 10. Comptroller John Dugan, a member of the FDIC board, expressed his opinion in a board meeting as follows:

> In short, denying an ILC application for deposit insurance based merely on commercial affiliation would be fundamentally inconsistent with first, the express congressional exemption of ILCs from the Bank Holding Company Act's restriction on commercial affiliation, and second, the FDIC's track record in addressing risks raised by such affiliations during the last 20 years. The continued ability of commercial firms to own ILCs will undoubtedly be a close and difficult policy decision for Congress, but it is not a close decision for me as a legal determination to be made by this agency. As a result, if Congress fails to change the law permitting commercial ownership of ILCs during the extension of the moratorium, and if a deposit insurance application is submitted thereafter by an ILC with commercial affiliations, I will not vote to deny the application merely because of that affiliation. In the meantime, I strongly urge Congress to address this issue.

John C. Dugan, Comptroller of the Currency, Statement to the FDIC Board of Directors Regarding the ILC Moratorium Extension 4 (Jan. 31, 2007), http://www.occ.treas.gov/news-issuances/news-releases/2007/pub-other-state-2007-aa.pdf [hereinafter Dugan Statement].

79. Press Release, Fed. Deposit Ins. Corp., FDIC Extends Moratorium on Industrial Loan Company Applications by Commercial Companies for One Year; Will Move Forward on Applications from Financial Companies (Jan. 31, 2007), http://www.fdic.gov/news/news/press/2007/pro7007.html.

80. *Id.*

than 13,800 letters regarding Wal-Mart's proposed ILC.[81] Most comments were in direct opposition to Wal-Mart being granted a charter, but some also raised concern about the ILC industry in general.[82] In May 2007, the House passed legislation that would suspend any further commercial ownership of ILCs.[83] During the eighteen month FDIC moratorium, however, Wal-Mart conceded to the massive opposition and withdrew its application.[84] Home Depot, along with several other commercial firms, also withdrew its application, taking the momentum away from the ILC opposition.[85]

Jane Thompson, president of Wal-Mart Financial Services, justified the withdrawal, stating that "[s]ince the approval process is now likely to take years rather than months, we decided to withdraw our application to better focus on other ways to serve customers."[86] The FDIC and other federal regulators welcomed the news.[87] FDIC Chairman Sheila C. Bair stated that "Wal-Mart made a wise choice. This decision will remove the controversy surrounding their intentions."[88] Others, including the American Bankers Association (ABA) remained apprehensive of the ILC charter and called for change, stating that "Wal-Mart's withdrawal of its ILC application is a welcome development, but we urge Congress to continue its work to close the ILC loophole once and for all. The central concern in the ILC debate—the separation between banking and commerce—remains, even with today's announcement."[89]

It was Wal-Mart's suspected desire to enter full-scale banking that drove the opposition to both its application and the ILC industry.[90] Many worried that despite its stated intention, Wal-Mart planned to open a national bank that could drive traditional retail banks out of business by offering competitive pricing on its financial products.[91] Although banking law would potentially allow such an expansion,[92] Wal-Mart stated,

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81. Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg. 5290, 5291–92 (Feb. 5, 2007).

82. *Id.*

83. Adler, *supra* note 77, at 1. This legislation as well as Senate Legislation on ILCs will be discussed in detail in the next section.

84. *See* Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5218–19 (Feb. 5, 2007); Parija B. Kavilanz, *Wal-Mart withdraws industrial banking push*, CNN/MONEY (Mar. 16, 2007, 12:30 PM), http://money.cnn.com/2007/03/16/news/companies/walmart/index.htm.

85. Adler, *supra* note 77, at 1. Of the fourteen pending applications before the moratorium, only three remained. "[O]nly one—Chrysler Financial's, involve[d] a commercial parent." *Id.*

86. Kavilanz, *supra* note 84.

87. *Id.*

88. *Id.*

89. *Wal-Mart Drops Bid to Form Bank*, INS. J. (Mar. 16, 2007), http://www.insurancejournal.com/news/national/2007/03/16/77810.htm.

90. Liza Featherstone, *The Bank of Wal-Mart?*, THE NATION (Aug. 31, 2005), http://www.thenation.com/article/bank-wal-mart.

91. *See* ICBA Letter, *supra* note 74, at 2–4.

92. According to Utah law, after three years, an ILC is no longer bound to their original business plan, and if the board approves a change, the ILC charter could be amended to include national branching. *See* 12 C.F.R. § 333.101(a) (2007). The amendment to the

before dropping their bid, that it would be willing to accept a charter that prohibited any future branching.[93] Despite the company's denials that it did not intend to establish banking branches or engage in lending,[94] the fears that it would do so appear to be somewhat justified. Wal-Mart has attempted to enter banking, in one form or another, for over a decade.[95] Moreover, Wal-Mart already operates a full service bank in Mexico,[96] and many fear that it will do the same in the United States because of its repeated attempts to enter banking.[97] Wal-Mart could have a damaging effect on community banking should it choose to enter banking and use predatory pricing as it has in the past.[98] The anti-competitive fears of a

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charter would also have to be approved by the FDIC. Wal-Mart's ILC could potentially branch into twenty-two states that either allow the ILC charter or have agreed to the opt-in provisions under the Riegle–Neal Interstate Banking and Branching Act of 1994. Lloyd, *infra* note 94, at 226.

93. *See* Industrial Loan Companies and Industrial Banks, 71 Fed. Reg. 49,456, 49,458 (Aug. 23, 2006); Lloyd, *infra* note 94, at 227.

94. Rob Garver, *Wal-Mart's Financial Vision: In Retail: Focus on Unbanked, Partnerships, Home Grown ATMs*, AM. BANKER, Oct. 5. 2005, at 1. "According to Jane Thompson, the President of Wal-Mart Financial Services, Wal-Mart had no desire to establish branches or engage in lending, and the ILC was 'not a bank a consumer [would] ever see.' In addition, Thompson pointed out that Wal-Mart actively encourages community banks to open branches in its stores." Zachariah J. Lloyd, *Waging War with Wal-Mart: A Cry for Change Threatens the Future of Industrial Loan Corporations*, 14 FORDHAM J. CORP. & FIN. L. 211, 227 (2008) (citations omitted). "Wal-Mart currently has arrangements with more than 300 banks, which operate more than 1,100 branches in Wal-Mart stores across the country." Garver, *supra*, at 1.

95. Kevin K. Nolan, *Wal-Mart*'s Industrial Loan Company: The Risk to Community Banks, 10 N.C. BANKING INST. 187, 191–92 (2006) (describing various attempts by Wal-Mart to purchase banks in Oklahoma, California, and a national bank chain, TD Bank, all of which having been blocked by state or national regulators); *see also* Bloomberg News, *Wal-Mart Wants To Buy Savings and Loan*, N.Y. TIMES, June 30, 1999, at C31.

96. Carolyn Whelan, *Wal-Mart gets its bank—in Mexico*, CNN/MONEY (Jan. 29, 2008, 4:08 AM), http://money.cnn.com/2008/01/28/news/international/walmart_bank.fortune/index.htm.

97. Wal-Mart attempted once before to establish a California ILC, but the California legislature, in an obvious attempt to target Wal-Mart, passed legislation barring commercial ownership of ILCs. Rob Blackwell, *Wal-Mart After ILC Again, This Time in Utah Met with FDIC, ICBA; Top Exec. Said Picked for Card-Focused Unit*, AM. BANKER, Mar. 8, 2005, at 1; Christine Daleiden, *Wal-Mart: The Debate over Commercial Ownership of Industrial Loan Companies*, 11 MAR. HAW. BAR J.23; 25–26 (2007); *see also* Nicola Leiter, *Wal-Mart's Industrial Loan Company*, 25 ANN. REV. BANKING & FIN. L. 101, 101–02 (2006).

98. Camden Fine, President of the Independent Community Bankers of America (ICBA): "Fifteen years ago, Wal-Mart said it had no designs on the grocery business and 20 years ago, they said they had no designs on the hardware business but now they dominate both businesses." Lloyd, *supra* note 94, at 227–28 (citing Shaheen Pasha); *Wal-Mart Bank faces tough opposition*, CNN/MONEY (Jan. 4, 2006, 1:46 PM), http://money.cnn.com/2006/01/04/news/companies/walmart_bank/). Through their use of "predatory pricing and other techniques," they tend to "run all local competition out of business." *Id.* at 227 (citing Letter from Sound Banking Coalition to John F. Carter, Reg'l Dir., Fed. Deposit Ins. Corp. 6 (Aug. 17, 2005), http://www.icba.org/files/ICBASites/PDFs/sbc081705.pdf). "Typically, after Wal-Mart expands into another sector of the market and reduces local competition—or does away with it entirely—Wal-Mart frequently increases its own prices." *Id.* at 228 (citing Nolan, *supra* note 95, at 194). "An Iowa State University study revealed that after Wal-Mart's expansion into Iowa, 555 grocery stores, 298 hardware stores, 293 building materials stores, and 116 drug stores closed their doors." *Id.*; *see also* KENNETH E. STONE, COMPETING WITH THE DISCOUNT MASS MERCHANDISERS, 23 tbl. 2 (1995), *available at*

hypothetical Wal-Mart national bank have driven much of the opposition to the ILC charter,[99] but the arguments waged against the ILC have focused on safety and risk concerns, which if legitimate would be a valid reason to discontinue the charter.[100] This Article will address these arguments and show that they are not legitimate. If Wal-Mart were to operate a national bank, it may pose a significant competitive risk to community banking but would be among the safest banks in the country because it would be backed by a large, highly capitalized, and stable commercial giant.[101]

D. CONGRESSIONAL LEGISLATION

The House Committee on Financial Services (Committee) held a hearing in 2006 regarding industrial banks.[102] The general counsels from the FDIC and the Federal Reserve Board, as well as many other industry observers, testified before the Committee, discussing many facets of industrial banks.[103] In May 2007, the House passed the Industrial Bank Holding Company Act of 2007 (H.R. 698), which prohibited commercial firms from acquiring ILCs, by a vote of 371–16.[104] Under the bill, a company is considered "commercial if it derive[s] 15% or more of its gross revenue, on a consolidated basis, from non-financial activities."[105] H.R. 698 also gave the FDIC supervisory authority over any parent company

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http://www.econ.iastate.edu/faculty/stone/1995_IA_WM_Study.pdf (as cited in Lloyd, *supra* note 94, at 228). Other studies indicate that "for every Wal-Mart 'Supercenter' opened, two local groceries will close." *Id.* at 228–29 (citing Nolan, *supra* note 95, at 194). Therefore, Nolan concludes, a Wal-Mart ILC could damage "the community banking industry (if a Wal-Mart ILC charter is amended to include full retail banking services) in each of its Supercenters nationwide. *Id.* at 229 (citing Nolan, *supra* note 95, at 194).

99. *See* Wendy Zellner, *Wal-Mart: Your New Banker?*, BLOOMBERG BUSINESSWEEK (Feb. 5, 2007), *available at* http://www.businessweek.com/magazine/content/05_06/b3919046_mz011.htm; *see also* Michelle Clark Neely, *Industrial Loan Companies Come Out of the Shadows*, THE REG'L ECONOMIST (Fed. Res. Bank of St. Louis, St. Louis, Mo.), July 2007, http://www.stlouisfed.org/publications/re/articles/?id=27.

100. *See* Neely, *supra* note 99.

101. *See* Suzanne Struglinski & Jenifer K. Nii, *Wal-Mart bank delayed*, DESERET NEWS, Feb. 1, 2007, at E1; *see also* Letter from David B. Winder, member of Bd. Of Dirs. For Wal-Mart Bank, to Sheila C. Bair, chairman of Fed. Deposit Ins. Corp. (Oct. 10, 2006), *available at* http://www.fdic.gov/regulations/laws/federal/2006/06c100ilc.pdf (last visited Aug. 4, 2010).

102. *Industrial Loan Companies: A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services,* 109th 1 Cong. (2006).

103. Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5219 (Feb. 5, 2007) (to be codified at 12 C.F.R. pt. 86.).

104. Press Release, H. Comm. on Financial Services, House Overwhelmingly Passes Industrial Bank Holding Company Act (May 21, 2007), http://financialservices.house.gov/press110/press052107.shtml. *See* H.R. 698, 110th Cong. (1st Sess. 2007). Congressman Gillmor and Financial Services Committee Chairman Barney Frank introduced H.R. 698 on January 29, 2007. Press Release, H. Comm. On Financial Services, *supra.* Similar legislation was introduced in the Senate. *See* S. 1356, 110th Cong. (1st Sess. 2007).

105. H.R. 698 also exempts commercial companies that already own ILCs from this prohibition under a grandfather provision. *See* H.R. REP. NO. 110-155, at 9 (2007); *see also* H.R. 698, 110th Cong. § 51(c), (f)(2)–(3) (1st Sess. 2007).

of an ILC.[106]

The Senate did not respond with similar legislation at the time and the FDIC's moratorium expired on January 31, 2008, but was subsequently re-installed by the Dodd–Frank bill.[107] Several states also enacted legislation that would prohibit or restrict ILCs chartered in other states from establishing branches in their states.[108] The broader financial collapse has focused lawmakers on more comprehensive banking reform, making it unlikely that an act targeted at a particular banking charter will be discussed in the legislature. However, the ILC was discussed in the proposed White House and Senate bills addressing broad banking changes and was part of the Dodd–Frank reform package.[109]

E. White House and Senate Legislation

On June 17, 2009, the Obama administration released a comprehensive plan for regulatory reform, which proposed an extensive overhaul of bank regulation and regulatory structure.[110] As part of the plan, referred to as "The White Papers," the administration proposed a stricter separation of banking and commerce as well as a complete ban of the ILC charter.[111] The final Dodd–Frank bill, which was passed in July 2010, issued a three-year moratorium on new ILC charters and directed the GAO to conduct a study on the ILC charter to determine its safety and soundness.[112] Industry observers believe that it is unlikely that the administra-

106. H.R. 698; *see* H.R. Rep. No. 110–115, at 9.

107. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 603, 124 Stat. 1376, 1597 (2010) (to be codified at 12 U.S.C. § 1815). In February 2008, Senator Dodd attempted to approve a bill in the Senate Banking Committee that would ban commercial ownership of ILCs. *Legislative Update*, Am. Banker, Feb. 14, 2008, at 7. The bill did not gain enough votes to pass the committee and, if revisited, is unlikely to pass on the floor of the Senate for several reasons. First, the moratorium allowed the FDIC to evade the decision completely rather than merely delaying it because Wal-Mart dropped its bids and thus deflated the controversy surrounding ILCs. Alder, *supra* note 77, at 1. Second, the bill included a large exemption for automakers, which happen to be the only type of commercial firm currently seeking ILC charters, thereby making the legislation a symbolic gesture. *Id.* This huge exemption seems to suggest that the opposition was aimed at Wal-Mart rather than at ILCs. Given the current economic climate, it is unlikely that the government would deny automakers charters for ILCs because it could provide them needed liquidity. A May 2, 2007 mark-up of the passed House legislation also included a large exception for automakers. *See Legislative Update*, Am. Banker, May 10, 2007, at 7.

108. Lloyd, *supra* note 94, at 232 n.151. These states are Iowa, Maryland, Missouri, Wisconsin, Virginia, and Vermont. *Wal-Mart's Industrial Loan Company Talking Points*,Wal-Mart Watch, http://walmartwatch.com/img/documents/ILC.pdf (last visited May 17, 2010); *see, e.g.*, Va. Code Ann. § 6.1-232.2 (Supp. 2009) (repealed by Act 2007, c.1, cl.2, eff. Feb 5. 2007).

109. *See, e.g.*, Treasury Blueprint, *supra* note 67, at 39; *infra* note 110.

110. Dep't of Treasury, Financial Regulatory Reform: A New Foundation (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf; *see also* Stephen Labaton, Some Lawmakers Question Expanded Reach for the Fed, N.Y. Times, June 17, 2009, at B1.

111. Harry Terris, *Pros, Cons of Unplugging GE Capital from Its Parent*, Am. Banker, Nov. 11, 2009, at 1; *see also* Hopkins & Adler, *supra* note 5, at 1.

112. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 603, 124 Stat. 1376, 1597 (2010) (to be codified at 12 U.S.C. § 1815).

tion will achieve a ban on the ILC charter because it is widely recognized that the charter had nothing to do with the financial crisis.[113] In addition, there are many powerful supporters of the ILC on both sides of the political spectrum who advocate for its continued existence.[114] Nevertheless, the ILC has received national attention once again because of its unique status at the intersection of commerce and banking.[115] Now that the dust has settled from Wal-Mart's original application and the financial crisis has provided a new context to think about banking, it is time to revisit the ILC issue in a new light.

III. THE DEBATE

A. VALUE OF THE ILC

Ownership of an ILC "is effectively the only vehicle by which nonfinancial firms can enter banking, and by which nonbank financial firms can own a depository institution without being subject to holding company supervision . . . ."[116] Non-BHCs seeking to conduct credit or banking activities can do so mainly through an ILC or one of the few and limited financial firms that are not classified as banks.[117] Many commercial firms, such as automakers, extend credit as part of their core business; the safest and most competitive way for these firms to fund financing is through a bank because they can avoid the transaction costs of dealing with outside lenders.[118] Although parent companies do not use ILCs to finance their own operations, they often use ILCs to offer complementary products and services to enhance the parent's core businesses.[119]

Commercial firms have established ILCs to meet various business and financing demands.[120] Indeed, the rapid growth of the industry shows that the ILC model has met a rising demand. For example, the investment banking firm of Merrill Lynch, which formerly owned the largest ILC, Merrill Lynch Bank, USA, focused on consumer and business

113. *See* Hopkins & Adler, *supra* note 5.

114. Senator Reid, Congressman Frank, Senator Bennett, and Senator Dodd all support the ILC charter and hold pivotal positions on the Senate and Congressional banking committees. *See* Stacy Kaper, *Lawmakers Doubt Key Goal of Reg Reform Plan*, AM. BANKER, June 19, 2009, at 1; Joe Adler, *Frank Favors Keeping Existing ILCs*, AM. BANKER, July 31, 2009, at 16; Emily Flitter & Stacy Kaper, *Most Likely to Succeed: Pieces of Obama Plan*, AM. BANKER, June 18, 2009, at 1. Note, however, that Senator Bennett and Senator Dodd will not be returning to the Senate next year so the case against ILCs may have been weakened due to the departure of these advocates or the ILC issue.

115. *See* Terris, *supra* note 111, at 1.

116. Ergungor & Thomson, *supra* note 42, at 2.

117. Commercial firms can own credit card companies, nondeposit trust companies, mortgage companies, or commercial or consumer finance companies without being subject to the BHC Act. S. REP. NO. 111-176, at 83 (2010). There are also various thrifts and nonbanks whose ownership was grandfathered in through CEBA and various other legislative actions. Johnson & Kaufman, *supra* note 20, at 40.

118. *See* Lloyd, *supra* note 94, at 245; Ergungor & Taylor, *supra* note 42, at 2.

119. Rule 23A forbids an ILC from funding the parent company. *See infra* notes 239–40 and accompanying text.

120. Ergungor & Thompson, *supra* note 42, at 2.

loans.[121] Large investment banks and financial institutions, such as Goldman Sachs, Morgan Stanley, and UBS, owned and operated many of the largest ILCs under a similar model.[122] Another model for ILC ownership is that of commercial and retail corporations, such as GE Capital and Target. These corporations use their ILCs to process financial transactions to enhance their retail operations.[123] A third group of ILC owners, including BMW and Volkswagen, use their ILCs to directly support their businesses by offering direct financing for their automotive sales.[124]

The rising desire for firms to enter financing and banking activities is fueled both by changes in the law and changes in the marketplace, including expanding credit options.[125] For decades, banks were the primary source of credit.[126] Today, companies and individuals have many non-bank options for obtaining credit.[127] Many companies want to own an ILC because it allows for greater efficiency and cost-reduction in their business operations.[128] There is a growing need for commercial firms to integrate different parts of their business as technology, and the changing face of banking and finance has allowed many firms to diversify their products and offer their customers a range of financing and credit options.[129]

There have been several large exceptions to both the moratorium and the proposed congressional legislation, demonstrating that Congress and the FDIC seem to recognize that the ILC structure serves a useful function.[130] As part of the automakers' plea for a bailout before Congress on December 4, 2008, Ford Motors testified that it needed an ILC to free up necessary capital to finance auto loans.[131] Ford intends to use its ILC as

121. Johnson & Kaufman, *supra* note 20, at 42.

122. *Industrial Loan Companies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 12–13 (2007) (statement of John F. Bovenzi, Chief Operating Officer, FDIC) [hereinafter Bovenzi Attachment]; Steve Sloan & Joe Adler, *What Future May Hold for Two Converts*, AM. BANKER, Sept. 23, 2008, at 1.

123. Johnson & Kaufman, *supra* note 20, at 43.

124. GAO REPORT, *supra* note 10, at 18.

125. Sutton Testimony, *supra* note 23, at 11.

126. *Id.* at 52.

127. *Id.*

128. *Id.* at 52–53.

129. *Id.* at 52.

130. For example, in November of 2006, the FDIC set the moratorium aside for GMAC's ILC so that it could approve Cerberus Capital Management's purchase of the ILC. Press Release, Fed. Deposit Ins. Corp. FDIC Press Release No. 103-2006, FDIC Bd. Approves Change in Control Notice for GMAC Auto. Bank (Nov. 15, 2006) (on file with author). In a press release, the FDIC stated that it needed to act on this ILC "to avoid the potential for substantial interference with a major restructuring by General Motors Corporation." Marcy Gordon, *GMAC Bank Takeover is Approved*, DESERET NEWS, Nov. 16, 2006, at E4. Additionally, the FDIC also suspended its moratorium to grant WellPoint Inc. permission to obtain FDIC insurance for its ILC. Joe Adler, *ILC Gets OK After Unusual Consultation*, AM. BANKER, Sept. 13, 2007, at 1; *see also* Peter J. Wallison, *Viewpoint: Carveout Reveals ILC Bill's True Nature*, AM. BANKER, June 29, 2007, at 11.

131. "Having an Industrial Loan Company will place us on a more equal footing with our major competitors who already have such banks. More importantly, it will benefit consumers by providing us another resource for reasonably priced capital, thus helping us provide credit to our customers and dealers," the submission said. Ford Motor Company,

other automakers are using theirs—as a source of credit for its customers and dealers.[132] The notion that automakers should be given an exception to own an ILC because of their financial weakness subverts the argument that the separation of banking and commerce is needed to protect the safety and soundness of the banking system.[133] The Federal Reserve Board states that their regulation of BHCs is "necessary to ensure they will remain sources of strength for their subsidiary banks."[134] But Congress seems to now be saying that a weak parent company should be granted an exception because of its greater need for the charter.[135] It seems that the driving force opposing the ILC derives less from concerns about maintaining safety and soundness in banking and more from a desire to exclude certain companies from the banking sector.[136]

B. ARGUMENTS AGAINST THE ILC

A broad range of groups have voiced arguments against the ILC around two themes.[137] First, on a practical level, opponents of the ILC fear that the lack of federal consolidated supervision for parent companies of ILCs endangers the stability of the financial system.[138] Second, and on a more theoretical level, opponents believe that the charter is an exception to the long history of separation of banking and commerce that the government has imposed in order to protect the safety and soundness of the banking system.[139] This latter argument did not originate with the ILC charter or the Wal-Mart application but was rejuvenated by both.[140]

Business Plan, Submitted to the Senate Banking Committee, Dec. 2, 2008, at 5, http://banking.senate.gov/public/_files/Brfg12308AutoPRESENTATIONOFFORDMOTORCOMPANY122_SenateFinal_.pdf (last visited May 18, 2010).

132. Editorial, *Ford Bets the Farm and Sells the Company Jets*, JUST-AUTO (Dec. 2, 2008), http://www.just-auto.com/article.aspx?id=97032.

133. Wallison, *supra* note 130, at 11.

134. *Id.*

135. *Id.*

136. *See generally id.* (arguing legislation is more about protecting the banking industry from competitors).

137. The arguments are gathered from Congressional testimony during the House's examination of the ILC following the FDIC moratorium as well as several other works of scholarship and industry reports. The most prominent critics of the ILC in recent years have included Rep. Jim Leach, the GAO, the ICBA, the ABA, and Federal Reserve Vice Chairman Donald Kohn. *See* Kohn Testimony, *supra* note 51, at 12–13; *id.* at 38–40 (testimony of James P. Ghiglieri, Jr. for the ICBA); *id.* at 40–41 (testimony of Earl D. McVicker for the ABA); GAO REPORT *supra* note 10, at 82–86; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, INDUSTRIAL LOAN CORPORATIONS RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY TESTIMONY BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT, *Committee On Financial Services, House of Representatives* 3–4 (2006), *available at* http://financialservices.house.gov/media/pdf/071206rjh.pdf. For recent arguments against ILCs, see Wilmarth, *supra* note 25, at 1588. *See also* Arthur E. Wilmarth, *Viewpoint: Giving GMAC Aid Would Be Big Mistake*, AM. BANKER, Dec. 3, 2008, at 10.

138. GAO REPORT, *supra* note 10, at 33.

139. Wilmarth, *supra* note 25, at 1570–71.

140. The Federal Reserve and the FDIC have largely shaped the debate over the mixing of banking and commerce. Two important presentations of the long debate are the 1982 essay, *Are Banks Special?*, written by Gerald Corrigan, then President of the Federal Reserve Bank of Minneapolis and the 1987 bank study released by the FDIC, *Mandate for*

Some also oppose the ILC because they claim that it is a regulatory loophole that the government needs to close and that the ILC exception allows commercial firms to "evade" U.S. banking laws.[141] However, the ILC is not a product of an unintended loophole; rather, it is a product of several legislative measures dating from 1956 to 1999 expressly exempting ILCs from BHC Act restrictions.[142] Regardless, the loophole argument does not address the safety of the ILC, which is the only appropriate reason to close an ILC "loophole," if there is one. As I will demonstrate, the arguments against the ILC have not successfully established that the charter poses a threat to the safety and soundness of our financial system or that ILCs are more risky or prone to failure than commercial banks.[143] Conversely, the evidence shows that ILCs are among the safest banks in the country after having been tested by the recent financial crisis—a result, I argue, of their unique commercial partnerships.[144]

1. Need for Federal Consolidated Bank Supervision

Many opponents of the ILC argue that the charter is more prone to risk because a commercial parent company of an ILC is not subject to federal consolidated supervision.[145] As Donald L. Kohn, Vice Chairman of the Board of Governors of the Federal Reserve System, expressed:

> [Federal Consolidated Supervision] allows the Federal Reserve to understand the financial and managerial strengths and risks within the consolidated organization as a whole and gives the supervisor the authority and ability to identify and resolve significant management, operational, capital or other deficiencies within the overall organization *before* they pose a danger to the organization's subsidiary insured banks.[146]

The BHC Act mandates that the FRB, the Office of Thrift Supervision (OTS), and the FDIC, which together serve as federal consolidated supervisors, regulate any company that owns a bank.[147] Because parent companies of ILCs are not BHCs, they are not subject to federal consolidated supervision.[148] State regulators and the FDIC regulate ILCs; the

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Change. E. Gerald Corrigan, *Are Banks Special?*, FED. RES. BANK OF MINNEAPOLIS ANN. REP. (1982); FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY (1987) [hereinafter FDIC, MANDATE FOR CHANGE].

141. *ILCs-A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit, H. Comm. on Financial Services* (June 12, 2006) (testimony of Scott G. Alvarez, General Counsel, Board of Governors Federal Reserve System) [hereinafter Alvarez Testimony].

142. The BHC exempted ILCs and the exception was held and even expanded by the Garn-St. Germain Act (1982), CEBA (1987), and the GLB (1999). *See* Johnson & Kaufman, *supra* note 20, at 39–41. The GLB retained the original CEBA provisions and added a more liberal element to the exemption. *See* 12 U.S.C. § 1841(c)(2)(H) (2006).

143. *See infra* part III.B.1.

144. *See infra* part III.B.2.e.

145. *See* Wilmarth, *supra* note 25, at 1617; Kohn Testimony, *supra* note 51, at 12–13.

146. *See Kohn Testimony*, *supra* note 51, at 132.

147. 12 U.S.C. §§ 1841, 1843 (2006).

148. *See* Kohn Testimony, *supra* note 51, at 12–13.

relevant industry regulator, usually the Securities and Exchange Commission (SEC), regulates the parent companies.[149] However, this argument rests on the assumption that a broad regulator of the parent company is able to detect risk better than the bottom-up approach of the FDIC.[150]

If it were proven that federal consolidated supervision could reduce risks in the banking system, the government could easily remedy the problem by bringing commercial parents of ILCs under federal oversight.[151] The White Papers suggest a greater regulatory reach over companies that are financially relevant but not over BHCs.[152] The commercial parents of ILCs are already highly regulated entities that could be subjected to further oversight without having to change their core business to control a bank, as the BHC Act requires.[153] However, the critics have not shown evidence suggesting that the Federal Reserve's approach is any more effective than the approach of the FDIC and the state regulators. In fact, the Federal Reserve has recently come under intense criticism, and virtually every comprehensive banking reform proposal addresses the fundamental weaknesses of the Federal Reserve's monitoring system and proposes changes to that structure.[154]

The FDIC has both the authority and the capacity to effectively regulate ILCs and their parents.[155] The FDIC and the state regulators of ILCs have proven to be capable regulators and have formed and followed a rigorous system for evaluating and managing risks.[156] ILCs that are owned by commercial firms have rarely caused significant supervisory problems, and their record of safe and sound practices compares favora-

149. *See* West, *supra* note 9, at 6 n.8. Ed Leary explains, "While not subject to regulation as bank holding companies, industrial bank owners are subject to many of the same requirements as bank holding companies. As a result, safeguards already exist to protect these depository institutions against abuses by the companies that control them or activities of affiliates that might jeopardize the safety and soundness of the institutions or endanger the deposit insurance system." Leary Testimony, *supra* note 19, at 165.

150. *See* Kohn Testimony, *supra* note 51, at 12–13.

151. A common regulator with plenary oversight responsibility over the many players in our financial system could ensure the safety of our system by regulating all affiliate relationships between the various commercial, financial, and banking players. In 2008, the Treasury stated: "A single prudential regulator focusing on safety and soundness of firms with federal guarantees, similar to the OCC, but with appropriate authority to deal with affiliate relationship issues. Prudential regulation in this context would be applied to individual firms, and it would operate like the current regulation of insured depository institutions, with capital adequacy requirements, investment limits, activity limits, and direct on-site risk management supervision. The prudential regulator would oversee firms with explicit government guarantees." TREASURY BLUEPRINT, *supra* note 67, at 18.

152. The White House proposal states that companies that are Tier 1 FHCs, defined as systemically important financial firms, would be regulated by the Federal Reserve. Strictly commercial firms would not qualify as Tier 1 FHCs. *See* Dep't of Treasury, *supra* note 110, at 10.

153. Sutton Testimony, *supra* note 23, at 52.

154. *See* Labaton, *supra* note 110.

155. *See* Sutton Testimony, *supra* note 23, at 7–8; Jones statement, *supra* note 14, at 10–13.

156. Jones Statement, *supra* note 14, at 19–20.

bly with other depository institutions.[157] It has not been shown that the types of risk that threaten banks have more to do with the identity of the regulator or the owner as opposed to the management of the individual institution.[158]

The FDIC manages every stage of ILC conversion, including evaluating all entry applications and sometimes requiring a change of structure as a precondition to acceptance.[159] The FDIC has the same supervisory powers over the parent companies of ILCs that it has over the parent and affiliates of any other bank; that is, the FDIC's oversight and enforcement power extends to the parent or affiliates of any bank whose activities affect that bank.[160] The FDIC has statutory authority to examine and take action against any ILC affiliate in order to protect it from risky actions by affiliates,[161] including issuing a cease-and-desist order.[162] In fact, the FDIC has used this power on several occasions to reach outside a bank in order to manage risk. Most notably, the FDIC recently issued a cease-and-desist order to an ILC's corporate parent for problems relating to the underwriting of subprime mortgages.[163]

Similarly, the State of Utah, which is the primary state regulator for most of the nation's ILCs, has developed a sophisticated monitoring system and has plenary control over both ILCs and their parent companies.[164] Utah's application process is very similar to that of the FDIC and examines the parent's reputation and financial standing as well as several

157. *See generally* CANTWELL F. MUCKENFUSS III & ROBERT C. EAGER, *The Separation of Banking and Commerce Revisited*, *in* THE MIXING OF BANKING & COMMERCE 39 (2007). "'As Chairman Bair stated at the 2007 House Hearing: 'FDIC supervisory policies regarding any depository institution, including an ILC, are concerned with organizational relationships, particularly compliance with the rules and regulations intended to prevent potentially abusive practices. . . . The FDIC's overall examination experience with ILCs has been similar to the larger population of insured institutions, and the causes and patterns displayed by problem ILCs have been like those of other institutions.' She noted no instance of FDIC enforcement due to abusive practices." *Id.* at 59 n.59.

158. Press Release, Donald E. Powell, Chairman, FDIC, The ILC Debate: Regulatory and Supervisory Issues, Remarks Before the Conference of State Bank Supervisors (May 30, 2003) [hereinafter Powell Remarks]. Donald Powell, reflecting on two decades of FDIC experience, states: "It is important to note here that risk posed by any depository institution depends on the appropriateness of the institution's business plan and model, management's competency to run the bank, the quality of the institution's risk-management processes, and, of course, the institution's level of capital . . . . Further, the firewalls and systems of governance safeguarding ILCs from misuse by their parent companies are, in many cases, more stringent than what exists in many affiliates of bank holding companies. In part, the generally positive experience of the ILC charter in recent years is attributable to a continually evolving supervisory approach that considers each institution's purpose and placement within the organizational structure." *Id.*

159. 12 U.S.C. § 1819(a) (2006) (expanding the FDIC's incidental powers).

160. *Id.* § 1820(b)(2). For a comprehensive view of FDIC supervisory power and authority, see West, *supra* note 9, at 5–13.

161. 12 U.S.C. § 1820(b); *see also id.* § 1820(b)(4)(A).

162. In addition to cease and desist powers, the FDIC can impose civil money penalties, involuntary termination of insurance, or divestiture. 12 U.S.C. § 1818(b), (c), (d), (e), (i).

163. Press Release, FDIC, FDIC Issues Cease and Desist Order Against Fremont Investment and Loan, Brea California, and Its Parents (Mar. 7, 2007).

164. *See generally* Leary Remarks, *supra* note 53.

other factors before approving an ILC charter.[165] Utah can examine an ILC and take any enforcement or remedial action necessary against a bank and any affiliate.[166] The state can force a change of management, issue cease-and-desist orders, force mergers or acquisitions, and even take possession of the institution.[167] In addition, the Commissioner has the direct authority to take an enforcement action against the holding company or any affiliate.[168]

Some industry observers argue that Utah and FDIC oversight is more effective than federal consolidated supervision because it targets the safety of the bank and is not divided between different regulators.[169] Various regulators oversee traditional BHCs and their banks, and the process of communication is not always smooth.[170] Furthermore, Utah also participates in the FDIC's Large Bank Supervision Program (LIDI Program), which places a state regulator on-site at an ILC of a large or complex company at all times to ensure the safety and soundness of the ILC.[171]

The argument that ILC ownership by commercial firms should not be allowed because of the lack of federal consolidated supervision is not persuasive because it has not been proven that bank-centered supervision is less able to detect risk than top-down supervision or supervision of the parent. Bill Seidman, the former FDIC chairman, argued twenty years ago that the best way to achieve a flexible and sound financial system was to take a "bank-centric approach."[172] Seidman's advice "was to ensure that regulators be given sufficient powers to regulate the relationship between banking and commerce rather than not allow it."[173]

Notwithstanding, it is uncertain whether the structure or scope of a banking regulator can ensure safety in a banking system. A study conducted in 2002 analyzed bank performance and supervision in fifty-five countries and found "little support at best to the belief that any particular bank supervisory structure will greatly affect bank performance."[174]

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165. *See What is a Utah Industrial Bank?*, UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS, http://www.dfi.utah.gov/whatisIB.htm (last visited Oct. 7, 2010).

166. *See, e.g.*, UTAH CODE ANN. § 7-1-313 (LexisNexis 2009).

167. *Id.* §§ 7-1-307, 7-1-308, 7-2-1(3).

168. *Id.* §§ 7-1-307, 308, 313, 314, 501, 7-2-1.

169. Sutton Testimony, *supra* note 23, at 51–52.

170. *Id.* at 203–04.

171. Utah Commissioner Leary notes, "Utah is participating with the FDIC in the Large Bank Supervision Program for [several] industrial bank[s.] . . . . The supervision of these large banks is coordinated by a full-time relationship manger [sic] for the State as well as the FDIC." Leary Remarks, *supra* note 53, at 4. These examiners coordinate the implementation of the supervisory plan for each bank. This plan generally involves three targeted reviews that roll-up to an annual Examination Report that is reviewed with management and the board. *See id.*

172. SHEILA BAIR, *The Fourth Wave—The Mixing of Banking & Commerce*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 9, 11.

173. *Id.* at 11.

174. James R. Barth et al., *A Cross-Country Analysis of the Bank Supervisory Framework and Bank Performance*, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 67, 67 (2003).

Nevertheless, policymakers are currently engaged in the process of reforming and restructuring U.S. banking regulators in order to more effectively protect the banking sector and the economy from the failures that caused the recent credit crisis that crippled the nation's banks.[175] As they do so, they will need to reexamine some of the previously accepted principles of banking, such as which regulatory structure ensures safety and soundness. While that question is beyond the scope of this Article, the ILC supervisory structure is an example of the success of bottom-up supervision.

2. *Traditional Separation of Commerce and Banking*

The main argument waged against the ILC is that commercial ownership of the ILC goes against the traditional U.S. policy of separation of commerce and banking.[176] The separation of banking and commerce, however, is not a long-standing "tradition" but a restriction imposed through a few acts of legislation. The first legislative separation of banking and commerce occurred in the aftermath of the Great Depression, and the restriction against commercial firm ownership of banks, the main focus of this Article, did not begin until 1970.[177] "Until 1956, any corporation could own any number of commercial banks";[178] and until the passage of the second amendment of the BHC Act in 1970, any nonbank entity could own one commercial bank.[179] Though the wisdom of mixing banking and commerce is the subject of intense debate, many scholars have dispelled the notion that the separation of commerce and banking is a long-standing principle guiding U.S. banking history.[180] In fact, a 1987 FDIC study argues that there has never been a complete separation of

175. *See, e.g.*, TREASURY BLUEPRINT, *supra* note 67, at 1.

176. Wilmarth, *supra* note 25, at 1539; *see also* Paul Volcker, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Jan. 21, 1987), *in* 73 FED. RES. BULL., Mar. 1987, at 199; Alan Greenspan, H.R. 10, The Financial Services Competitiveness Act of 1997, Testimony Before the Committee on Banking and Financial Services, U.S. House of Representatives (May 22, 1997); James Ghiglieri Jr., President of Alpha Comty. Bank & Chairman of Indep. Cmty. Bankers of Am., Indus. Loan Cos., Testimony Before the U.S. House of Representatives Committee on Financial Services 2 (April 25, 2007), *available at* http://financialservices.house.gov/pdf/Ghiglieri.pdf [hereinafter ICBA Testimony] ("The ILC charter continues to threaten our nation's historic separation of banking and commerce and undermine our system of holding company supervision, harming consumers and threatening financial stability."); Kohn Testimony, *supra* note 51, at 1 ("If left unchecked, this recent and potential growth of firms operating under the [ILC] exception threatens to undermine the decisions that Congress has made concerning the separation of banking and commerce in the American [society].").

177. MUCKENFUSS & EAGER, *supra* note 157. *See generally* Haubrich & Santos, *supra* note 3, at 144.

178. Huertas, *supra* note 1, at 744.

179. *Id.* In 1970, the BHC Act defined the term "bank" for its purposes to be an institution that makes commercial loans *and* accepts deposits payable on demand; any other corporation could own commercial banks that fulfilled one condition but not the other. Carl Felsenfeld, *Non-Bank Banks: An Issue in Need of a Policy*, 41 BUS. L. 99, 109–11, 113 (1985).

180. *See* Huertas, *supra* note 1, at 755; Joseph G. Haubrich & Joao A.C. Santos, *Banking and Commerce: A Liquidity Approach* (Bank for Int'l Settlements, Working Paper No.

commerce and banking in America.[181]

At their inception, banks and commercial firms were difficult to distinguish and were all "merchant banks."[182] Most private banks were established only to support commercial trading activity, and many banks, such as Wells Fargo and J.P. Morgan, were directly involved in commercial ventures.[183] Some state charters even allowed banks to maintain an ownership position in other companies or to directly combine with them.[184] "[A] prominent example of the mixing of banking and commerce is the chartering of the Manhattan Company. In 1799, New York State granted a corporate charter to Aaron Burr for the establishment of a company to provide New York City with a safe water supply."[185] In addition to the water works, the charter also allowed Burr to establish a bank to finance the water works. "The Bank of the Manhattan Company was formed and became the largest bank in the city as well as the state, and survives today as Chase Manhattan Bank."[186] The Manhattan Company continued to sell water and engage in banking throughout most of the nineteenth century.[187]

In addition, many individuals held, and still hold, controlling shares in both banks and commercial firms.[188] In the nineteenth century, the banker-industrialists Thomas Mellon and Moses Taylor each owned controlling interests in banks and a variety of commercial enterprises.[189] In fact, Sam Walton of Wal-Mart was the chief executive and principal shareholder of Northwest Arkansas Bancshares, a BHC.[190] Directors on the boards of major U.S. banks are often affiliated with a broad range of corporations.[191]

78, 1999); *see also* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 98; Haubrich & Santos, *supra* note 3, at 121.

181. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 98. The study also argues that restriction on bank activities and affiliations, such as the Glass-Steagall Act and the BHC Act, should be abolished. *Id.* at 99–100.

182. Haubrich & Santos, *supra* note 3, at 128.

183. *Id.* at 127–28.

184. *Id.*

185. FDIC, MANDATE FOR CHANGE, *supra* note 140, at 24.

186. *Id.*

187. *Id.*

188. "In the nineteen [sic] century, for example, Moses Taylor owned controlling interests in the National City Bank (a forerunner of Citibank) . . . [as well as] a mercantile house, a gas utility and an iron company. Thomas Mellon started a private bank in Pittsburgh in the mid-nineteenth century and by the turn of the century the Mellon family owned controlling interests in Mellon National Bank, Gulf Oil, Alcoa Aluminum and various other industrial enterprises." Haubrich & Santos, *supra* note 3, at 155. For additional examples of investors that have had controlling interests in both banks and commercial firms simultaneously, see Huertas, *supra* note 1, at 744.

189. Huertas, *supra* note 1, at 744. For other examples, see Haubrich & Santos, *supra* note 3, at 155.

190. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 19; *see also* Haubrich & Santos, *supra* note 3, at 155–56.

191. *See* Haubrich & Santos, *supra* note 3, at 131, 155–56.

The Glass-Steagall Act (GSA),[192] which formally initiated a legal separation between banking and commerce in the United States, was a response to the Great Depression and the perception that banks with ties to corporations were too powerful and that these relationships led to the crash.[193] Many scholars have challenged this assertion.[194] Studies have shown that most of the abuses that arose during the 1920s appear to have reflected conflicts of interest pertaining to dealings with outside parties rather than transactions with banks and their affiliates, which is the aim of the GSA.[195] Increased oversight of the financial sector could have addressed the problems that led to the Great Depression without resorting to comprehensive activity restrictions. The FDIC observed:

> Until the 1930s, the securities affiliates of banks were not regulated, examined, or in any way restricted in the activities in which they could participate. Not surprisingly, abuses occurred. A certain degree of supervision and regulation and some restrictions on affiliate powers would have contributed significantly toward eliminating the types of abuses that occurred during this period.[196]

The GSA, which was enthusiastically accepted by Congress as the nation was reeling from the Great Depression, was based on fears of what could happen rather than a direct response to what actually did happen. Nevertheless, the Act's passage marks the beginning of a formal separation between banking and commerce in the United States.[197] The target of the GSA is the activities that can be conducted within a bank.[198] The Act does not allow banks to engage in commercial activities.[199] This separation still guides our banking laws today even though our system of banking would be practically unrecognizable to the regulators of the

192. The Glass-Steagall Act (named after its congressional sponsors, Senator Carter Glass and Congressman Henry Steagall) is found in the Banking Act of 1933 §§ 16, 20, 21, 32 (codified as amended at 12 U.S.C. §§ 24, 78, 377, 378 (1988)).

193. *See* Janet A. Broeckel, *Regulation of Bank Holding Companies' State Bank Subsidiaries That Engage in Nonbanking Activities: An Unjustified Extension of the Federal Reserve Board's Regulatory Power*, 4 ADMIN. L.J. AM. U. 169, 171–73 (1990). The GSA was enacted because of concerns about the risky behavior of commercial banks, such as "buying, selling, and underwriting questionably sound securities." *Id.* at 173 n.23; *see also* Haubrich & Santos, *supra* note 3, at 133.

194. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at ix ("It was demonstrated long ago, and in a convincing fashion, that the Great Depression in no way resulted from the common ownership of commercial and investment banking firms. The Glass-Steagall Act was largely the result of efforts by Senator Carter Glass, who was guided in his efforts by his belief in the discredited 'real-bills' doctrine."). For an explanation of the Real-Bills doctrine, see FDIC, MANDATE FOR CHANGE, *supra* note 140, at 44 ("Scholars have studied the record with great care since 1933. There is little or no evidence that the investment banking activities of commercial bank affiliates were a major cause of bank failures. To the extent that securities investments were a factor in bank failures, it was because of liquidity problems rather than credit-quality concerns. It is hard to imagine banks not having liquidity problems in the face of massive bank runs and no backup liquidity support, regardless of the types of earning assets in their portfolios.").

195. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 44.

196. *Id.* at ix.

197. Broeckel, *supra* note 193, at 172.

198. *Id.*

199. *Id.* at 172 n.22.

1930s.[200] The GSA, however, did half the job of separating banking and commerce because it only applied to banks, but not to holding companies.[201] That did not change until the 1950s.[202]

Congress extended the separation of banking and commerce initiated by the passage of the GSA to restrictions on the activities of owners of banks through the 1956 BHC Act and its 1966 and 1970 Amendments.[203] By most accounts, the BHC Act was aimed at the expansion of one corporation, Transamerica, and its principal aim was to prevent conglomeration in banking.[204] Transamerica Corporation was formed in 1930 and was structured as a holding company that owned many types of businesses, including banks, real estate, insurers, mortgagees, and even commercial fishing companies.[205] Transamerica wanted to create a nationwide bank, but the BHC Act, which prohibits any company that controls a bank from engaging in any non-banking or commercial activities, prevented this action.[206] The BHC Act initiated and completed the restrictions on ownership of banks by commercial firms. Scholars often cite the need to control expansion as the primary cause of the BHC Act.[207] Supporters of the BHC Act point out the potential for abuse when the same owner controls both banking and commercial firms; however, when BHCs were unregulated, there was little evidence of such abuse.[208] The real concern seemed to be that BHCs were seen as a threat to the existence of small unit banks.[209]

Congress viewed the separation of banking and commerce through the BHC Act as a way to prevent the concentration of power.[210] When Con-

200. Banks used to serve as the only source of credit. In our current securitized market, there are many sources for financing and banks compete with other credit markets such as the capital markets and commercial paper. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 6–7.

201. Broeckel, *supra* note 193, at 173.

202. Haubrich & Santos, *supra* note 3, at 140.

203. *See* Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 319 (1987).

204. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 36–50. "[I]n 1948 . . . [t]he Federal Reserve Board charged that Transamerica was in violation of the Clayton Antitrust Act by monopolizing commercial banking in [several states]. *Id.* at 31. "At that time, Transamerica controlled 46 banks, in addition to owning a large percentage of Bank of America." *Id.* "In 1952, the Board ordered Transamerica to divest itself of all its bank stock, except for Bank of America, within two years." *Id.* A Court of Appeals "[set] aside the Board's decision in 1953 [and decided that] [u]nder the Clayton Act . . . 'the Board failed to demonstrate that Transamerica's acquisitions substantially lessened competition among the acquired banks.'" *Id.*

205. J. Nellie Liang & Donald T. Savage, *The Nonbank Activities of Bank Holding Companies*, 76 FED. REG. BULL. 280, 280 n.1, 281 (1990).

206. Bank Holding Company Act of 1956, ch. 240, §§ 2–11, 70 Stat. 133–46 (codified as amended at 12 U.S.C. § 1843 (1988)). The Act also forces BHCs to divest of all interests in companies that are not considered banks under the BHC Act. *Id.* at §1843(a)(2).

207. *See* Liang & Savage, *supra* note 205, at 280; Fischel et al., *supra* note 203.

208. *See* Fischel et al., *supra* note 203, at 320; *see* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 31.

209. For an explanation of the origins of the BHCA, see Liang & Savage, *supra* note 205, at 280–81. *See also* Fischel et al., *supra* note 203, at 331.

210. Liang & Savage, *supra* note 205, at 280–81.

gress first passed the BHC Act, it exempted companies that held only one bank from the activity restrictions placed on companies that owned two or more banks.[211] Congress felt that the threat was contained in large multibank conglomerates and that, because most one-bank holding companies were small, they did not pose a problem.[212] However, in the three years after the passage of the 1966 Amendment, one-bank holding companies grew substantially and became the holders of some of the nation's largest banks.[213] Consequently, Congress amended the BHC Act in 1970 to bring one-bank holding companies under its supervision and, thus, initiated a complete restriction on commercial ownership of banks for the first time in U.S. history.[214] In explaining the passage of the 1970 Amendment, Congress conceded:

> In making this decision, the committee wishes to note its agreement with all of the Government regulatory agencies who testified that there have been no major abuses effectuated through the one-bank holding company device. It is clearly understood that the legislation is to prevent possible future problems rather than to solve existing ones.[215]

U.S. firms have attempted to circumvent the BHC Act's restrictions since its imposition.[216] Banks have tried to expand the definition of what business activities the BHC Act considers related to banking and, thus, permissible.[217] Each time, however, the legislature responded by narrowing the definition of what activities are considered "incidental" to banking[218] and finally issued a specific list of permissible bank activities.[219] Commercial firms bypassed the limitations of the BHC Act by establishing nonbank type entities that had one element of the banking definition but not the other.[220] Thus, companies were essentially using nonbank banks as a means of merging commerce and banking to meet the demands of their complex business operations.[221] Congress will either need

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211. *Id.* at 281.

212. FDIC, MANDATE FOR CHANGE, *supra* note 140, at 32; *see also* S. REP. NO. 84-1095, at 1 (1955), *reprinted in* 1956 U.S.C.C.A.N. 2482, 2482 ("[P]ublic welfare requires the enactment of legislation providing Federal regulation of the growth of bank holding companies and the type of assets it is appropriate for such companies to control.").

213. Haubrich & Santos, *supra* note 3, at 144.

214. *See* Johnson & Kaufman, *supra* note 20, at 39.

215. S. Rep. No. 91-1084, at 3 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5519, 5522.

216. Haubrich & Santos, *supra* note 3, at 143.

217. *Id.* at 150.

218. The Garn-St. Germain Act narrowed the scope of what is considered banking. Lloyd, *supra* note 94, at 213 (*citing* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.)).

219. For a comprehensive overview of U.S. banking law and the list of non-banking activities allowed by the Board, see A.M. POLLARD ET AL., BANKING LAW IN THE UNITED STATES 272–88 (2d ed. 1988).

220. Haubrich & Santos, *supra* note 3, at 147–49. "By late 1986, there had been applications for about 400 charters for nonbank banks submitted to the Comptroller of the Currency." *Id.* at 147.

221. Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System at the time, testified before the Senate Banking Committee: "Essentially, the nonbank

to recognize these loopholes or loosen the BHC Act's restrictions on banking activities.

Supporters of the BHC Act and the restrictions on commercial firm ownership of banks claim that the separation ensures the overall safety of banking. First, there are concerns that when banks and commercial firms affiliate, conflicts of interest will occur.[222] Second, proponents argue that unfair competition will result from the mixture.[223] Third, there are fears that financial and economic monopolies or conglomerates will be created that would foreclose competition.[224] Fourth, some individuals are concerned with the extension of the federal safety net to a commercial entity that a banking authority does not supervise.[225] Fifth, there is concern that the systemic risk increases when banking and commerce are mixed.[226] In the following section, I will explore each of these arguments in more depth.

a. Conflicts of Interest

Critics of the ILC state that the mixing of banking and commerce would "add to the potential for increased conflicts of interest and raise the risk that insured institutions may engage in anticompetitive or unsound practices."[227] Another fear is that banks affiliated with commercial firms may lend to their affiliates at much more preferable rates than other entities.[228] There is certainly potential for conflicts and abuse in many commercial and financial relationships.

Conflicts of interest already exist in commercial banks, among the different types of activities conducted by securities firms, and many other industries.[229] Conflicts of interest also abound in many types of commercial and financial enterprises. For example, there is a conflict of interest within many banks due to a security firm's role as an "impartial" investment advisor and its role as a promoter of investment products. Automobile dealers with service departments are in a position to misrepresent to their customers the condition of their cars in order to perform unneces-

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bank has become a device for tearing down the separation of commerce and banking by permitting a commercial firm to enter the traditional banking business without abiding by the provisions of the Bank Holding Company Act." Volcker, *supra* note 176, at 200.

222. GAO REPORT, *supra* note 10, at 72; *see also* ICBA Testimony, *supra* note 176, at 39; Kohn Testimony, *supra* note 51, at 24; Wilmarth, *supra* note 25, at 1549–50.

223. *See* Featherstone, *supra* note 90 (posing the question as to whether Wal-Mart would lend money to its direct competitors and the potential effects on the proposed bank if Wal-Mart goes bust); *see also* Raskovich, *supra* note 44, at 3.

224. *See generally* Jones Statement, *supra* note 14; Terry J. Jorde, President and CEO of CountryBank USA, FDIC Symposium, The Future of Banking: The Structure and Role of Commercial Affiliations (July 16, 2003), *available at* http://www.fdic.gov/news/conferences/future_jordespeech.html.

225. Jorde, *supra* note 224.

226. *See* Wilmarth, *supra* note 25, at 1543.

227. GAO REPORT, *supra* note 10, at 72; *see also* ICBA Testimony, *supra* note 176, at 39–40; Kohn Testimony, *supra* note 51, at 12–13; Wilmarth, *supra* note 25, at 1549–50.

228. Kohn Testimony, *supra* note 51, at 128.

229. Haubrich & Santos, *supra* note 3, at 138 (discussing conflicts of interest of bank directors with trust clients).

sary repairs or sell new cars. Real estate brokers face a conflict between their own interests to sell a property versus the seller's interest in securing the largest purchase price. However, banks and commercial firms can plausibly create internal separation between their commercial and banking activities.[230] In all of these enterprises, increasing disclosure and punishment for false or misleading statements could eliminate a conflict. Accordingly, regulators should eliminate informational asymmetries and increase oversight, supervision, and penalties for breach before an activity or affiliation is prohibited. These restrictions on ownership of banks came before any abuse or failed attempt at regulation instead of being imposed after abuses occurred and regulation was proven to be inadequate.[231] Before activity restriction, it needs to be demonstrated that existing controls are insufficient to prevent these types of conflicts of interest abuse in ILCs.[232] In the limited world of ILCs, there is evidence that such abuses have not occurred. Affiliations between commercial firms and banks have not resulted in any failures due to conflicts of interest or self-dealing of any kind in the time that ILCs have been owned by commercial parents.[233]

However, there is still a risk of potential abuse, and the risk of abuse arising from a conflict of interest is greatest when an affiliate is in danger of failing. For instance, when an affiliate needs substantial aid, an affiliate could force a bank to offer aid at the expense of its own solvency. The argument follows that an ILC would come to the aid of its commercial affiliates, or vice-versa, and each firm would risk its own safety to protect its affiliate, resulting in a conflict of interest. However, history does not support this fear. In the 1970s when rising interest rates threatened many bank-sponsored Real Estate Investment Trusts

230. Note that Michael Lewis contends in "The Big Short" that these so-called "Chinese Walls" that were supposed to function as barriers between different departments in large investment banks were not effective in the least. MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 204–05 (2010). However, it seems that the situations that led to the breaking of these "barriers" were ripe for abuse and unlike the relationship between a commercial parent and its banking subsidiary.

231. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 44 (noting that Congress made no attempt in the 1930s to test the effect of regulation and supervision before mandating an outright prohibition).

232. Donald Powell's remarks before Congress note the effectiveness of FDIC supervisory practices and also note that the FDIC has "found parent companies of ILCs to be acutely conscious of their responsibilities with respect to their ILC subsidiaries and the consequences of violating applicable laws and regulations." Powell Remarks, *supra* note 158. After an extensive study in the 1980s of the potential for conflict, the FDIC concluded: "Despite the widespread potential for abuse, there is little to suggest that conflict-of-interest abuse in the U.S. economy is at an unacceptable level. Those who make such claims bear the burden of proof, but they have presented no such proof . . . . Without evidence to the contrary, one must conclude that existing controls are adequate to prevent excessive conflict-of interest abuse. Nowhere is this more true than in the banking industry." *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 46; *see also* DEP'T OF THE TREASURY, MODERNIZING THE FIN. SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 29–36, 46–48 (1991); MUCKENFUSS & EAGER, *supra* note 157, at 57 n.36 (citing Rose Marie Kushmeider, *The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation*, 17 FDIC BANKING REV. 4, 13–15 (2005)).

233. *See infra* notes 363–67 and accompanying text.

(REITs), the banks that sponsored them came to their aid in many cases.[234] Regulators could have tried to discourage such activity, but in fact, the Federal Reserve supported and encouraged efforts by banks to save their REITs.[235] It is noteworthy, however, that not a single bank failed as a result of aid given to REITs.[236] Although there may be some incentives for banks to aid associated or affiliated firms, "there is no evidence from the REIT experience that the incentive is so great that a bank is willing to go down with the ship."[237] Several ILC owners have also experienced bankruptcy without resorting to taking funds from their ILCs.[238]

The fear that banks would make favorable loans to their affiliates also ignores the fact that preferential lending is illegal and that violators face severe penalties. This type of conflict is certainly a source of concern and could endanger a bank, but it is the exact conduct addressed by Sections 23A and 23B of the Federal Reserve Act, which limit transactions between a bank and its affiliates.[239] Similarly, section 23B of the Federal Reserve Act requires that any transaction between a bank and its affiliates needs to be "on terms and conditions, including credit standards, that are substantially the same, or at least as favorable to [the bank] as those prevailing at the time for comparable transactions" with unaffiliated companies."[240]

Despite these safeguards, abuses may occur, and regulators must vigilantly supervise banks to deter these types of offenses.[241] Fraud and

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234. FDIC, MANDATE FOR CHANGE, *supra* note 140, at 78.

235. *Id.* at 117 (citing Anthony Cornyn et al., *An Analysis of the Concept of Corporate Separateness in BHC Regulation From an Economic Perspective*, *in* PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION (Fed. Res. Bank of Chi., 1986).

236. *Id.*

237. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 118. This article also analyzes seven different situations where a safe wall was erected between an ailing bank and its bank holding company and the failure did not cause any loss to the FDIC insurance fund or danger to the bank. *Id.* at 118–24. The FDIC concludes that "effective insulation is possible . . . . Subsidiaries and affiliates can be protected against legal risks if certain procedures are followed to ensure that the operations are conducted in truly separate corporate entities . . . . [N]ew powers can be granted to banking organizations, with appropriate safeguards to ensure that the banking system remains safe and sound." *Id.* at 127.

238. *See infra* Part III.B.2.e and accompanying notes.

239. 12 U.S.C. § 371c(a)(2) (2008). There are also strict collateral requirements on any transactions between an ILC and its parent. *See* 12 U.S.C. § 371c(b)(E) (2008); *see also* § 371c(a)(1)(A)–(B) (stating that covered transactions with a single affiliate may not exceed 10% of the bank's capital and surplus and such transactions with all affiliates may not exceed 20% of the bank's capital and surplus).

240. 12 U.S.C. § 371c (1982), *amended by* Competitive Equality Banking Act of 1987, 12 U.S.C.A. § 371c-1 (1987).

241. CAMDEN R. FINE, *U.S. Households & The Mixing of Banking & Commerce*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 28, 31. Camden Fine expresses doubt about the effectiveness of firewalls: "In my view, regulatory 'firewalls' are like the French Maginot line, they are a monument to the folly of man. There is always a Rommel (or in our present context Keating, Lay, or Ebbers) that will devise a way around." *See also ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the H. Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 43 (2006) (statement of Rep. Barney Frank, Member, H. Comm. on Fin. Servs.) ("A lot of things have been dealt with by statute but, you know, you heard

abuse can occur despite the most comprehensive regulatory safeguards and oversight. With mixed results, Congress and the banking agencies have attempted to develop a strong and effective regime for protecting insured banks from abuse by insiders or affiliates.[242] There is certainly room for improvement in banking regulation in general. However, when there are laws designed to prevent abuse from conflicts of interest and there are regulators responsible for enforcing these laws, prohibiting commercial firms from owning banks because of the potential for a conflict of interest undermines regulators' abilities to control abuse.

As a 2005 FDIC study examining potential conflicts of interest concludes:

> On examination, the principal potential conflicts that are offered as a rationale for separating banking and commerce seem unlikely to pose significant risks to the safety and soundness of the bank or to the federal safety net . . . . [M]ost conflict situations affecting banks can be controlled through the supervisory process and enforcement of the appropriate firewalls and need not pose excessive risk to banks or the banking system.[243]

b. Unfair Competition

Opponents of the ILC assert that

> [t]he ILC exception fosters an unfair and unlevel competitive and regulatory playing field by allowing firms that acquire an insured ILC in a handful of states to operate outside the activity restrictions and consolidated supervisory and regulatory framework that apply to other community-based, regional and diversified organizations that own a . . . bank.[244]

Community banks, fearing that Wal-Mart will have an adverse effect on community banking, are the most vocal group opposing the ILC.[245] The Independent Community Bankers of America (ICBA) testified that some commercial firms that have applied for an ILC "have the size and resources to engage in predatory pricing for as long as it takes to drive the local competitors out of the market."[246] They claim that Wal-Mart will use its size and market dominance to undercut prices and drive com-

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about the statute of limitations. I'm going to give you a new concept—a limitation of statutes. Just because it's in the statutes doesn't mean that it's going to happen."); Wilmarth, *supra* note 25, at 1596 (stating that firewalls break down in times of financial stress).

242. *See* MUCKENFUSS & EAGER, *supra* note 157, at 47 (challenging the "assumption that commercial firms manage their business with less care for legal compliance and sound management principles than BHCs").

243. Christine E. Blair, *The Future of Banking in America, The Mixing of Banking and Commerce: Current Policy Issues*, 16 FDIC BANKING REV. No. 4, 97, 104 (2004).

244. Scott Alvarez, General Counsel, Fed. Reserve Bd., Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs (Oct. 4, 2007).

245. *See* ICBA Testimony, *supra* note 176, at 38–40; *see also* Letter from Greenville Community Bank to John F. Carter, Reg'l Dir. of FDIC (Sept. 20, 2005); Letter from Mark Nowak, Senior Lender, Farmers State Bank, to John F. Carter, Reg'l Dir. of FDIC (Sept. 19, 2005).

246. ICBA Testimony, *supra* note 76, at 39 n.40.

munity banks out of business.[247] For several decades, community bankers have directed this fear of "bigness" towards banking organizations due to the "special" nature of banks and their centrality to the country's financial system.[248] This fear was especially prevalent in the years immediately following World War II possibly because the popular feeling at that time was that close ties between banking and industry in the Axis Powers facilitated the events that led to the war.[249]

It is important to distinguish between unfair and fair competition—the latter being good for the market and the former damaging.[250] In a paper written for the Department of Justice Economic Analysis Group, Alexander Raskovich analyzed the Herfindahl–Hirshmann Index, a common measure of market concentration, to determine whether the mixing of banking and commerce would lead to any market foreclosure or monopoly concerns.[251] The study concludes that "so long as commercial rivals have good alternative sources of credit, concerns with 'competitive inequality' in lending are misplaced."[252] Raskovich states that even in a rural banking situation where banks are more concentrated, vertical integration, or the affiliation of a bank and a commercial firm, is unlikely to lead to attempts to foreclose rivals.[253] He also notes that banks are no more vulnerable to market foreclosure than many other industries stating, "[i]n comparison with many other industries, banking appears neither exceptionally concentrated nor unusually susceptible to foreclosure risks."[254]

In addition, the changes in the U.S. banking system over the last decade weaken these anti-competitive fears. U.S. banking has seen incredible growth and expansion due to the 1994 Reigle–Neal Interstate Branching Statute, which has expanded the ability of banks to expand across state lines, making national banking much easier and allowing banks to "shop" for competitive state regulations and rates.[255] Moreover, internet and communications advances have made fundamental changes to the banking industry and allowed for many additional banking players to enter the finance and credit market, formerly dominated by traditional

247. *Id.*

248. *See generally* Corrigan, *supra* note 140.

249. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 1–14.

250. Considering Wal-Mart's past practices, a Wal-Mart national bank could certainly have a damaging effect on small banks across the U.S. However, if regulators decided to limit Wal-Mart's expansion into national banking, they could do so without disrupting a successful and safe industry and without using Wal-Mart as a stand-in for the larger debate about the mixing of banking and commerce.

251. Raskovich, *supra* note 44, at 4.

252. *Id.* at 3.

253. *Id.* at 5.

254. *Id.* at 6.

255. Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified at 12 U.S.C. § 1831u(a)(1)) (permitting BHCs to acquire control of out-of-state banks regardless of state law prohibitions and allowing interstate branching by foreign and domestic BHCs).

banks.[256] These changes have reduced barriers to entry for many small banks and have allowed for banks to compete for customers through the internet. ILCs would only increase healthy competition in the banking sector by allowing new entrants to enter banking. Although advances have allowed increased competition, the banking sector is becoming increasingly dominated by a small number of large and powerful banks that have been backed by funds from the federal government.[257] Small- and mid-sized banks have become more vulnerable because they are not "too big to fail."[258] Experts predict that this conglomeration will continue and accelerate as the banking crisis continues and small banks can no longer survive.[259] The funding structure of ILCs provides a way for small- and medium-sized banks to survive with backing from a commercial parent rather than from the federal government.

As noted, fears of unfair competition most likely center on the threat of a hypothetical "Wal-Mart national bank."[260] In fact, Wal-Mart has already entered into some forms of banking without any major consequences to its banking competitors.[261] Wal-Mart has been marketing the debit card for the past few years and has also been offering money transfer services, check cashing services, and money orders at significantly lower prices than its competitors.[262] Wal-Mart stores process about one million financial transactions a week.[263] There is no indication that Wal-Mart is pricing Western Union or its other competitors out of business.

Wal-Mart has a potential banking customer base different than traditional retail banks. Analysts have estimated that about one-fifth of Wal-Mart customers do not have bank accounts, a ratio twice the national rate.[264] Consequently, Wal-Mart could have a positive effect on U.S. banking by targeting the "underbanked" and "unbanked" and providing them with much-needed financial services, such as bank accounts and financing. Consumers would benefit from a Wal-Mart bank because Wal-Mart could provide banking services at lower prices to a largely over-

256. THOMAS F. HUERTAS, *The Mixing of Banking & Commerce: The Union of Banking and Commerce—A Bridge Too Far, or Just Another Turn in the Road?*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 62, 62.

257. *See* Arthur Wilmarth, *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 963–1050 (2009).

258. *Id.*

259. *Id.*

260. Joe Adler, *Review 2007/Preview 2008: ILC Bill's Prospects Wane as Sense of Urgency Fades*, AM. BANKER, Dec. 31, 2007, at 1. George Sutton, the Utah representative for the ILC industry, argues however, "industrial banks have made it clear that they would agree to a prohibition on branching by a commercially owned industrial bank . . . . That essentially precludes Wal-Mart from doing what everybody was afraid they would do in the future." *Id.*

261. Garver, *supra* note 94, at 1.

262. *Id.*; *see also* Weston, *supra* note 50 (noting, for example, that for a wire transfer to Mexico, Wal-Mart charges $10 compared to $14.99 at Western Union).

263. Weston, *supra* note 50.

264. *Id.*

looked clientele.[265] For example, Wal-Mart has been providing the same banking services that it provided to their employees to a low-income, largely Hispanic population not served by traditional banks.[266]

A Wal-Mart bank could be large and competitive without being unfair or unsafe, and it could be an adequate competitor to the large banks that currently have the majority of the market power in our banking system.[267] In fact, it seems to be the fear of *fair* competition driving some of the opposition to ILCs. Lawrence White testified before Congress:

> The executives of small banks have a history of claiming dire consequences every time a state legislature contemplated allowing expanded intra-state branching privileges . . . . [D]espite the consolidation, [however,] thousands of new (de novo) banks have been formed over the past few decades, as enterprising bankers have seen and embraced new business opportunities, often in the wake of mergers. . . . A similar pattern could be expected if an expanded Wal-Mart bank were to leave the financial needs of groups of customers unfulfilled. America's bankers may not like the competition; but they are creative and resourceful, and most will survive.[268]

c. Fear of Conglomerates and Monopolies

The fear of monopolies has been an argument against the mixing of banking and commerce since the start of banking and has "great populist appeal."[269] Critics fear that the "mixing of banking and commerce could promote the formation of very large conglomerate enterprises with substantial amounts of economic power. If these institutions were able to dominate some markets, such as the banking market in a particular local area, they could impact the access to bank services and credit for custom-

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265. *See* Michael Barbaro & Eric Dash, *At Wal-Mart, a Back Door Into Banking*, N.Y. TIMES, June 21, 2007, at C1.

266. THOMAS FRIEDMAN, THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY 161–62 (2007).

267. Wilmarth, *supra* note 257, at 963–1050 (stating that banking has experienced a massive conglomeration as a result of current banking crisis and that a few large and powerful firms now control the majority of market share).

268. White Testimony, *supra* note 48, at 219; *see also* Powell Remarks, *supra* note 158 ("Many worry about competition in the future that may come from new entrants into the ILC environment. I understand these fears. After all, I was a community banker once and I know all too well the pressures these institutions feel every day . . . . [W]hile I understand the anxiety some people have on this issue, fear of competition should not be the compelling argument in formulating good public policy.").

269. "[This argument] can be traced back at least to Andrew Jackson's 'war' in the 1830s against the Second Bank of the United States, and elements of the argument were already present in the debates concerning the chartering of the nation's first banks during the late 18th and early 19th centuries." Huertas, *supra* note 1, at 748. For modern arguments focused on the fear of a concentration of power, see JAMES LEACH, *The Mixing of Commerce and Banking*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 13, 18 ("fundamentally what is at issue is a concentration of power"). *See also* FINE, *supra* note 241, at 29 ("That nagging doubt in the back of everyone's mind over missing banking and commerce is our collective culture's deep distrust of concentrated power in any one or few hands.").

ers in those markets."[270] Although concern with power concentration is legitimate, addressing such concerns through limiting activities or restricting affiliations is "a blunt instrument approach" that denies the competitive benefit of new entrants into the system.[271] Thomas Huertas addressed this contention when it arose two decades ago:

> It is instructive to note that in the bank war of the 1830s, great numbers won out over great size, and that generally remains the rule in politics today. Fears that free entry into financial services would result in excessive political power seem overdrawn. . . . Any law that restricts entry confers wealth on the people owning the entities that are protected from competition, and this tends to create a constituency in favor of the law.[272]

Other scholars have also criticized the assertion that the mixing of banking and commerce would lead to large conglomerates with excessive economic power.[273] Given the structure of our economy and our antitrust laws, they feel that this argument is misplaced.[274] Competition from outsiders into the banking market can be beneficial to customers, especially to those underserved by existing banks. It is interesting to examine the critiques against conglomerates given our current economic climate where banks have been forced to join together either by federal mandate or by market pressure, a process that has saved many banks from collapse.[275] In the last year, the banking sector has seen an unprecedented rate of conglomeration among BHCs.[276] Many small banks have failed, and large banks have joined together to seek stability.[277] This is ironically a result of the BHC Act, which was formed to prevent conglomeration.[278] Banks have been forced to merge with one another because of capital and stability concerns, and due to the BHC Act restrictions, they can only join other banks or bank holding companies, causing a conglomeration in banking.[279]

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270. GAO REPORT, *supra* note 10, at 72–73; *see also* Kohn Testimony, *supra* note 51, at 128 ("Congress expressed concern that allowing banks and commercial firms to affiliate with each other could lead to the concentration of economic power in a few very large conglomerates.").

271. MUCKENFUSS & EAGER, *supra* note 157, at 52.

272. Huertas, *supra* note 1, at 748 (citing George G. Stigler, *The Theory of Economic Regulation*, 1 BELL J. ECON. MGMT. SCI. 3–21 (1971)).

273. *See generally* Nisreen H. Darwish & Douglas D. Evanoff, *The Mixing of Banking and Commerce: A Conference Summary*, CHI. FED. LETTER, Nov. 2007, *available at* http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/2007/cflnovember2007_244a.pdf.

274. *Id.*

275. JP Morgan Chase was forced to buy Bear Stearns; Barclays bought some of Lehman, JPMorgan Chase bought Washington Mutual, Wells Fargo bought Wachovia, etc. *See generally SOS: 'Save Our Stocks' A Look Back at a Year of Bailouts, Underwater Investors and Sunken Hopes*, WALL ST. J., Jan. 2, 2009, at R9–R11.

276. *FDIC Failed Bank List*, FDIC, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Oct. 13, 2010).

277. *See* Eric Dash, *Failures of Small Banks Grow, Straining F.D.I.C.*, N.Y. TIMES, Oct. 11, 2009, at A1; SOS, *supra* note 275, at R9–R11.

278. *See* MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS 2–42 (3d ed. 2001).

279. *See id.* at 2–42; SOS, *supra* note 275, at R9–R11.

Although it is often assumed that conglomerates present a threat to safe and fair banking, even before this current crisis, some have argued that conglomerates can provide substantial economic benefits.[280] For example, John Hawkes, former U.S. Comptroller of the Currency, stated that, "conglomerate ownership of banking institutions particularly ownership by financial conglomerates properly managed and appropriately regulated and supervised can provide opportunities for greater profitability, can offer consumers significant advantages, and can add strength to the financial system."[281] In addition, there is no reason to presume that fewer large banks would lead to more failures than many small banks. The 1987 and 2008 crises both led to many small banks failing, which had a devastating effect on the entire economy.[282] Notably, the Canadian banking system, which has been one of the most healthy and resilient during the recent financial collapse, is structured around a few large banking conglomerates that are highly regulated and diversified.[283] Many have recently suggested that the U.S. structure should mimic that of Canada and allow the nation's banks to form conglomerates to avoid the failure of hundreds of small banks, as is currently anticipated.[284]

d. Extension of the Federal Safety Net

A principal concern in the mixing of banking and commerce is that it extends to commercial firms the federal safety net that the government designed specifically for banks.[285] This argument assumes that commercial affiliations increase risk and that commercial firms are inherently more risky and prone to failure than banks. There is little validity to this point. In fact, it can be argued that it has been the banks that have taken excessive risks because they have been taking risks with their investors and depositors' money with the full backing of the FDIC insurance fund and, ultimately, the protection of the Federal Reserve.[286]

Still, critics argue that FDIC insurance would effectively act as a subsidy to save a commercial parent if the ILC or its parent is deemed "too big to fail."[287] Arthur Wilmarth, a vocal opponent of the ILC, recently

280. *See generally* John D. Hawke, Jr., Former U.S. Comptroller of the Currency, Remarks to the 16th Special Seminar on International Finance of the Japan Financial News Co., Ltd. (Nov. 16, 2005).

281. *Id.*

282. Eric Lipton, *F.D.I.C. Raises Fees to Replenish Bank Fund*, N.Y. TIMES (Feb. 27, 2009) http://www.nytimes.com/2009/02/28/us/politics/28web-banks.html.

283. *See* Paul Krugman, Op-Ed, *Good and Boring*, N.Y. TIMES, Feb. 1, 2010, at A19; Theresa Tedesco, Op-Ed, *The Great Solvent North*, N.Y. TIMES, Feb. 28, 2009, at A23.

284. *See* Krugman, *supra* note 283, at A19; Tedesco, *supra* note 283, at A23.

285. *See* GAO REPORT, *supra* note 10, at 8; ICBA Testimony, *supra* note 176, at 99–101; Kohn Testimony, *supra* note 51, at 128; Jorde, *supra* note 224; Wilmarth, *supra* note 257, at 1079.

286. PIERGIORGIO ALESSANDRI & ANDREW G. HALDANE, BANK OF ENGLAND, BANKING ON THE STATE 8 (2009), *available at* http://www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf (arguing that banks have an incentive to take risks and be overleveraged because of the banking of the state).

287. A scenario often presented considers if Enron had an ILC. Emil Lee, *First Bank of Wal-Mart?*, MOTLEY FOOL (Nov. 20, 2006), http://www.fool.com/investing/value/2006/11/

made this argument in opposing using TARP funds to bail out GMAC.[288] He argues that the federal government's bailout of GMAC is an extension of the federal safety net to a nonfinancial industry.[289] The argument rests on the fear that because the FDIC is not the primary regulator of the parent companies of financial firms, the FDIC "cannot monitor the business practices of the commercial owner or its affiliates to reveal potential risks to the soundness of the entire group or the ILC."[290] Opponents assume that if there were a problem at the parent level, the FDIC could not reach the parent, which would allow the bank to fail and lead to FDIC insurance being used to protect the entire organization.[291] As previously discussed, the FDIC is armed with sufficient oversight and enforcement powers to prohibit certain ownership arrangements and to stop harmful activities of ILC commercial parents.[292] If there is a potential for risk, the FDIC will prohibit bank ownership in the first place and, subsequently, take measures to reduce risk within a commercial-banking affiliation.[293]

In addressing this fear, it is important to consider the ILC structure and its history of commercial ownership coupled with FDIC insured banks. A review of the record demonstrates that FDIC funds have never been used to help an ILC with a commercial parent.[294] Throughout the history of ILC existence, including the current financial crisis, not one commercially-owned ILC has failed or caused even one dollar of loss to the FDIC insurance fund.[295] As the nation's small and large banks are failing at a dramatic rate, the lack of any ILC failures stands in sharp contrast to the trend and testifies to the charter's stability. Consequently, ILCs do not pose any more risk to the deposit fund than any other commercial firm. The GAO Report concluded "from an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions."[296] Past failures of ILCs have not been caused by their commercial affiliations but rather "from faulty strategic or tactical decisions."[297]

20/first-bank-of-walmart.aspx. *See generally Consideration of Regulatory Reform Proposals: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 338–40 (2004) (written testimony of Ed Mierzwinski, Director of Consumer Protection, U.S. Public Interest Research Group & Margot Saunders, Managing Attorney, National Consumer Law Center).

288. *See generally* Wilmarth, *supra* note 137.

289. *Id.*

290. Ergungor & Thomson, *supra* note 42.

291. *Id.*

292. *See* Blair, *supra* note 70, at 109.

293. *Id.*

294. *See* West, *supra* note 9, at 6–8.

295. Leary Testimony, *supra* note 19, at 191–92; *see also* Telephone Interview with Darryle Rude, Supervisor of Industrial Banks for the State of Utah (Dec. 2, 2009); *Failed Bank List*, FDIC, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Oct. 7, 2010).

296. GAO REPORT, *supra* note 10, at 24.

297. Blair, *supra* note 70, at 114.

One study concludes that there would not be any significant trickling out of FDIC funds to banking affiliates if banks were more integrated with commercial firms.[298] Moreover, the author states that it is likely that "under the current regulatory regime much or all of any safety net subsidy is already trickling out to commercial borrowers" because, in a competitive industry, any reduction in cost is passed through to customers in the form of lower prices.[299]

If policymakers want to eliminate the subsidy altogether, they could reprice deposit insurance to take into effect the trickling out of the benefit across the market.[300] Another measure to protect FDIC insurance would be to establish cross-guarantee liability for commercial owners as well as affiliates of ILCs, whereby the commercial owner and all of its affiliates would have to pay any deposit insurance liabilities before any money from the FDIC insurance fund is used.[301]

Admittedly, ILCs are susceptible to all of the risks and mismanagement of a parent commercial firm.[302] Further, commercial activities "provide a host of ways for [banks] to increase risk."[303] For example, a troubled bank could hide its poor assets on the books of a commercial parent, or an ailing commercial parent could potentially cause the demise of its affiliate bank. However, in over two decades of commercial ownership of ILCs, this has not happened.[304] Commercial firms have failed without affecting their ILCs largely due to effective regulation and regulatory firewalls.[305]

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298. Raskovich, *supra* note 44, at 6–7.

299. *Id.* at 7.

300. Since deposit insurance does not base premiums on risk exposure, there is a need to monitor and limit the risk-taking activities of insured banks. In the absence of such oversight, the incentives created by mispricing may result in excessive losses to the insurance fund. FDIC, MANDATE FOR CHANGE, *supra* note 140, at 109. For an analysis of the problems facing the deposit insurance system, see Huertas, *supra* note 1, at 752–55.

301. Currently, the ILC owner is liable for losses, but affiliates of that owner are not. Letter from Donald Powell, Chairman, FDIC, to Robert F. Bennett, U.S. Senate (Apr. 30, 2003), *available at* http://www.fdic.gov/news/conferences/future_bennett.html ("[a]s part of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress established a system that generally permits the FDIC to assess liability across commonly controlled institutions for FDIC losses caused by the default of one of the institutions. Currently, cross-guarantee liability is limited to insured depository institutions that are commonly controlled as defined in the statute. The definition of 'commonly controlled' limits liability to insured depository institutions that are controlled by the same depository institution holding company, i.e., either a bank holding company or a savings and loan holding company. Since the parent company of an ILC is neither a bank holding company nor a savings and loan holding company, ILCs that are owned by the same parent company would not be 'commonly controlled.' As a result, cross-guarantee liability may not attach to ILCs that are owned by the same parent company.").

302. Kohn Testimony, *supra* note 51, at 128; Raskovich, *supra* note 44, at 8.

303. John Krainer, *The Separation of Banking and Commerce*, ECON. REV. (Fed. Res. Bank of San Fran.), Jan. 1, 2000, at 23.

304. *See* Leary Testimony, *supra* note 19, at 191–92.

305. *Id.*

e. Systemic Risk and the Stability of the ILC Model

Most opponents of the ILC and the mixing of banking and commerce claim that allowing commerce and banking to mix increases systemic risk in the banking industry.[306] Recent congressional testimony by America's Community Bankers states: "These risks [of preferential lending and other support for commercial affiliates], combined with the rapid growth of ILCs create systemic risk concerns."[307] The GAO report claimed that because ILCs have not been tested during a time of "economic stress," it could still be assumed that they increased systemic risk.[308] In the absence of comprehensive studies to determine the systemic risk of ILCs, the current crisis has served as an excellent "testing ground" for identifying risky banking structures. The ILC industry has been vindicated through its success and stability, while other banks have faltered by the hundreds.[309]

Recent and historic examples demonstrate that when a parent commercial firm faces financial trouble and even bankruptcy, their ILCs do not suffer.[310] When Lehman Brothers Holding Inc. (Lehman Brothers) failed, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve, stated that even if the Board of Governors wanted to save the firm, they could not do so because the problems were too deep and Lehman's pledged collateral was essentially worthless.[311] Nevertheless, when Lehman Brothers fell apart, their ILC remained sound.[312] Darryle Rude, the industrial bank supervisor for the Utah Department of Financial Institutions, explains:

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306. *The Industrial Bank Holding Company Act of 2007: Hearing on H.R. 698 Before the H. Comm. on Financial Servs.*, 110th Cong. 84 (2007) (prepared statement of Arthur R. Connelly, First Vice Chairman of America's Community Bankers).

307. MUCKENFUSS & EAGER, *supra* note 157, at 40, 55 n.7 (citing written Testimony of America's Community Bankers on the Industrial Bank Holding Company Act of 2007 before the Committee on Financial Services of the U.S. House of Representatives (*ILCs—A Review of Charter, Ownership, and Supervision Issues: Hearing Before the H. Subcomm. On Financial Institutions and Consumer Credit*, 109th Cong. 9 (2006)).

308. *See* GAO REPORT, *supra* note 10, at 7 (stating that ILCs have "been refined during a period of time described as the 'golden age of banking' and has not been tested during a time of significant economic stress").

309. *Failed Bank List*; *see also* Lipton, *supra* note 282 (stating that more banks have failed in the first quarter of 2009 than in 2008 and predicting that over 100 banks will fail in 2009).

310. *See generally* John Cassidy, *Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis*, THE NEW YORKER, Dec. 1, 2008, *available at* http://www.newyorker.com/reporting/2008/12/01/081201fafact_cassidy?currentpage=all.

311. *Id.* ("Remarkably, once the potential bidders dropped out, Bernanke and Paulson never seriously considered mounting a government rescue of Lehman Brothers. Bernanke and other Fed officials say that they lacked the legal authority to save the bank. 'There was no mechanism, there was no option, there was no set of rules, there was no funding to allow us to address that situation,' Bernanke said last month, at the Economic Club of New York. 'The Federal Reserve's ability to lend, which was used in the Bear Stearns case, for example, requires that adequate collateral be posted. . . . In this case, that was impossible—there simply wasn't enough collateral to support the lending. . . . With Bear Stearns, with all the others, there was a point when someone said, "Mr. Chairman, are we going to do this deal or not?" With Lehman, we were never anywhere near that point. There wasn't a decision to be made.'"); *see also infra* note 313 and accompanying text.

312. *See* Cassidy, *supra* note 310.

> The industrial bank is very safe and sound. It is well capitalized and liquid, and has very good earnings. While other banks have been suffering over the last several quarters, Lehman Brothers Commercial Bank actually has been performing very well . . . . We have lived through this scenario before where a parent company has filed bankruptcy, and the subsidiary bank was disposed of in an orderly fashion.[313]

Since the bankruptcy, Lehman Brothers' ILC has converted to Woodlands Commercial Bank. Although, it faces struggles similar to most banking institutions in the country, it is still operating.[314]

Other prominent examples of situations where the bankruptcy of a parent did not affect its ILC are Conseco, Inc. ("Conseco"), Tyco International Ltd. ("Tyco"), and more recently, Flying J, Inc. When Conseco filed for bankruptcy, its ILC remained solvent and healthy.[315] In fact, the Conseco ILC was sold for a profit in the orderly liquidation of the insurance company.[316] As Tyco was failing, the state of Utah took control of its ILC and sold it in an Initial Public Offering (IPO) without the ILC's assets suffering any loss.[317] Tyco's former ILC was purchased by CIT bank, and that bank also survived the failure of its parent company.[318] A more recent example is Flying J, Inc., which is the largest retailer of diesel fuel in the West.[319] When the company entered Chapter 11 bankruptcy due to fuel price fluctuations, its ILC, Transportation Alliance Bank, was unaffected and its balance sheets remained strong.[320] The parent company, although in Chapter 11, remains a source of strength for the bank.[321]

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313. Joe Adler, *What Moves Mean for I-Banks' Thrifts and ILCs*, AM. BANKER, Sept. 16, 2008, at 3.

314. Patrick Fitzgerald, *Lehman Seeks to Inject Cash to Save Banks from Regulators*, DOW JONES FINANCIAL INFORMATIONAL SERVICES, Feb. 12, 2009.

315. The following is the FDIC summary of the Conseco failure: "Despite the financial troubles of its parent and the parent's subsequent bankruptcy . . . Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, $323 million of the $1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC—Conseco Bank, renamed Mill Creek Bank—which was purchased by GE Capital. As a testament to the Conseco Bank's financial health at the time of sale, the $323 million was equal to the book value of the bank at year-end 2002." *See* Blair, *supra* note 70, at 114. For the GAO's discussion of Conseco, see GAO REPORT, *supra* note 10, at 69.

316. Telephone Interview with Darryle Rude, Supervisor of Industrial Banks for the State of Utah, (Jan. 28, 2009); *see also* Blair, *supra* note 70, at 114.

317. Leary Testimony, *supra* note 19, at 192.

318. Telephone Interview with Darryle Rude, *supra* note 316; *see also* Karen Shaw Petrou, *Special Cases: Parent Fails, Bank Lives*, AM. BANKER, Nov. 11, 2009, at 9. This article notes that the dissolution of the CIT and Capmark parent commercial firms and the survival of their banks is unprecedented. The article does not mention that the banks were formerly ILCs, which I believe is the reason the seamless dissolution was possible.

319. *See generally Company History of Flying J Inc.*, FUNDING UNIVERSE, http://www.fundinguniverse.com/company-histories/Flying-J-Inc-Company-History.html (last visited July 22, 2010).

320. Telephone Interview with Darryle Rude, *supra* note 316.

321. *Id.*

Not only have ILCs not suffered because of their failing parents, they have also been aided by their commercial parents, even those that have weakened. The relative safety of these ILCs in times of financial stress is mainly due to the ILCs' commercial alliances, their access to a deep pool of funds from their parents, and the ability of each ILC's financing arm to function independently from its commercial parent.[322] They are independent from their parents because their operations, assets, and liabilities are separate from their commercial parents—a separation enforced by regulators.[323] But they can rely on their commercial parent in times of need for access to capital.[324] This relationship exists because of their parents' diversified products and because each large commercial parent has a vested interest in its bank's survival.[325] If the bank falters, the commercial firm will have to pay before the federal government pays, which is not the structure of most BHCs that do not have an independent source of funds besides their subsidiary banks.

Perhaps the most illustrative example of the protection offered by the ILC model in a time of financial trouble is the case of General Electric (GE) and its ILC, GE Capital, Inc. GE has suffered significant losses in the last several years and GE's ILC has also suffered due to defaulting loans in its portfolio.[326] GE's ILC and its parent have an income maintenance agreement wherein the GE parent funnels cash to its financing arm when it falls below a threshold.[327] They injected $9.5 billion in the first quarter of 2009 and will continue to support the ILC.[328] The stable earnings of the parent company stand behind the ILC's debt and allows the ILC to withstand losses of assets in its portfolio. However, GE's ILC has its own customers and independently originates loans for many small- and medium-sized businesses.[329] GE's ILC, headquartered in Salt Lake City, is now the forty-sixth most profitable bank in the country in spite of GE's trouble.[330] Most ILCs have similar income maintenance agreements, and several have been aided by their parent companies in the last two years during times of significant financial pressure.[331]

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322. *See* Letter from Donald Powell, *supra* note 301. (Chairman, FDIC on The Future of Banking: The Structure and Role of Commercial Affiliations, to Robert F. Bennett, Senator, U.S. Senate (Apr. 30, 2003), *available at* http://www.fdic.gov/news/conferences/future-bennett.html.)

323. *See id.*

324. Letter from Robert McKew, Senior Vice-President & General Counsel, American Financial Services Association, John L. Douglas, Partner, Alston & Bird LLP, to Robert Feldman, Executive Secretary, FDIC (Oct. 5, 2006), *available at* www.atsaonline.org.

325. *Id.*

326. Steve Lohr, *G.E.'s Earnings Fall 47%, Led by Finance Unit*, N.Y. TIMES, July 18, 2009, at B3.

327. Harry Terris, *Pros, Cons of Unplugging GE Capital from Its Parent*, AM. BANKER, Nov. 11, 2009, at 1.

328. *Id.*

329. Eric Lipton, *Citing Risks, U.S. Seeks New Rules for Niche Banks*, N.Y. TIMES (Sept. 17, 2009), http://www.nytimes.com/2009/09/17/business/economy/17industrial.html.

330. *Id.*

331. *See* Letter from Donald Powell, *supra* note 301.

It is not unique for a parent company to aid its subsidiary bank during a system-wide financial crisis. The failure of thrifts in the 1980s is also instructive in examining relationships between parent companies and their subsidiary financial institutions.[332] During that crisis, many commercial parents of thrifts were able to aid failing thrifts through capital infusions without suffering themselves.[333] Lawrence White, a member of the FHLBB, examined the crisis after he left office. In discussing savings-and-loan holding companies during the crisis, White concludes, "[t]he presence of companies involved in markets as diverse as autos, steel, wood products, retailing, public utilities, insurance and securities as holding company owners of thrifts has not created problems; the same would surely be true if these, or similar, companies had owned banks."[334]

Commercial entities do not pose a greater risk than financial parents.[335] Instead of increasing systemic risk, I argue that the commercial partnership arrangements of ILCs reduce risks within banks and the system as a whole. If ILCs are expanded, there is always a possibility of unforeseeable risks that do not currently exist. But if it could be proved that the ILC created additional risks to the financial system, the question should center on the regulators' ability to manage such risks. Sheldon Woods, the President of the Association of Financial Services, stated that:

> [I]f the FDIC and the state of Utah can't effectively manage the risk associated with any [ILC applicant], then that is where the question lies . . . . If that risk cannot be effectively managed, then [our] position would be [that] we support the regulatory environment and [ILC applications] should not be approved.[336]

As discussed, the risks are minimal and ILC regulators are competently managing those risks.[337]

C. Moving to a Better Regulatory Approach

In 2008 the Treasury proposed a "Blueprint for a Modernized Financial Regulatory Structure" that describes the current regulatory system as an outdated structure that needs to evolve to meet the demands of the changing market. The fact sheet states:

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332. During the thrift crisis in California in the 1980s, commercial parents of thrifts served as an important source of capital. Muckenfuss & Eager, *supra* note 157, at 48 n.61.

333. *Id.* (citing Lawrence J. White, The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation 216 (1991)).

334. White, *supra* note 333, at 333.

335. The FDIC analysis, concludes: "As a rule . . . it likely will be difficult to generalize about the relative riskiness of different activities for banks. In particular it is apparent that commercial and financial activities will not be distinguishable on the basis of any inherent differences in risk." FDIC, Mandate for Change, *supra* note 140, at 63.

336. Lloyd, *supra* note 94, at 242 (citing *Industry Outlook: Banking & Finance*, Utah Bus., Mar. 2007, at 67, 72).

337. "We at the FDIC must all be vigilant in our supervisory role. But I will reiterate: The FDIC believes the ILC charter, *per se*, poses no greater safety and soundness risk than other charter types." Powell Remarks, *supra* note 158.

> The current regulatory framework for financial institutions is based on a structure that has been largely knit together over the past 75 years. It has evolved in an accretive way in response to problems without any real focus on overall mission: Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system during the Great Depression. Changes were made to the regulatory structure in the intervening years in response to other financial crises (e.g., the thrift crises of the 1980s) or as enhancements (e.g., the Gramm–Leach–Bliley Act of 1999), but for the most part the underlying structure resembles what existed in the 1930s. . . .
> Capital markets and the financial services industry have evolved significantly over the past decade. Globalization and financial innovation, such as securitization, have provided benefits to domestic and global economic growth; while highlighting new risks to financial markets. . . .
> These developments are pressuring the U.S. regulatory structure, exposing regulatory gaps and redundancies, and often encouraging market participants to do business in other jurisdictions with more effective regulation. As a result, the U.S. regulatory structure reflects an antiquated system struggling to keep pace with market developments while facing increasing challenges to anticipate and prevent today's financial crises.[338]

The comprehensive Dodd–Frank bill, which was passed following the public sentiments for change articulated in this pronouncement, fell short of modernizing today's banking system. What it effected, more modestly, was a regulatory clean-up and tinkering rather than a conceptual rethinking of the structure of banking. The separation of commerce and banking is one of these outdated ideas that needs to be reexamined in light of recent events. To operate properly, the financial regulatory structure must understand the changing nature of the banking market. The strict separation between commerce and banking does not reflect such an understanding. As the nature of banks and banking has changed over the last several decades, policymakers should reconsider the separation between commerce and banking.

IV: BENEFITS OF MIXING BANKING AND COMMERCE

A. THE CURRENT FINANCIAL CRISIS

The credit crisis that has debilitated many of our nation's financial institutions has demonstrated how quickly a contagion can spread through our nation's banks. Many banks have similar types of assets and loans, and when one source of capital is troubled, such as collateralized debt obligations linked to mortgage-backed securities, all of the banks experi-

338. Press Release, Fact Sheet: Blueprint for a Modernized Financial Regulatory Structure (Mar. 31, 2008), *available at* http://www.treas.gov/pres/releases/reports/Face_Sheet_03.31.08.pdf.

ence a similar loss.[339] Some institutions are more at risk than others, but when one large institution at the center of the country's financial system fails, it sends a ripple throughout the entire economy threatening to topple all the other financial institutions from which they have borrowed money and to whom they have served as a source of credit.[340] Many likened the initial banking collapse of 2008 to dominos or a house of cards to illustrate how interconnected the financial institutions have become and how prone to collapse they are when one party falters.[341] In effect, the crisis showed that a better source of strength for a bank is an entity whose liquidity is not dependent on the same infected financial system, rather than a financial holding company whose instability is directly correlated with the instability of the bank.[342] The current crisis has forced the Federal Reserve and Treasury, the only sources of stable liquidity, to step in and provide aid and capital for troubled institutions.[343]

Indeed, there is a need for a more stable source of capital, or uncorrupted assets, to stop the domino effect. In February 2008, the investment firm Bear Stearns Companies Inc. (Bear Stearns) almost collapsed overnight as it lost the confidence of its investors and, most importantly, its creditors before another investment bank, JP Morgan, saved it at the behest of the Federal Reserve.[344] Because Bear Stearns operates on a typical investment firm model of high-risk investments and short-term financing, once the downhill slide started, it was difficult to stop or even delay.[345] Bear Stearns suffered a bank-like "run" on its assets because of its short-term liability structure.[346] In the case of Bear Stearns, the Fed-

339. *See generally* Wolf Wagner, *The Broadening of Activities in the Financial System: Implications for Financial Stability and Regulation* 3 (Ctr for Econ. Research, Discussion Paper No. 2006-72) (arguing that banks have become increasingly homogenized).

340. *See generally* Edmund L. Andrews, *Obama Has No Quick Fix for Banks*, N.Y. TIMES, Jan. 21, 2009, at B1.

341. *News Hour* (PBS television broadcast Mar. 21, 2008) (Jim Lehrer used falling dominos to describe the fallout of the financial system); *House of Cards* (CNBC television broadcast Aug. 16, 2008), *available at* http://www.cnbc.com/id/28892719 (CNBC used a "House of Cards" analogy in describing the events).

342. Many of the institutions that failed or were bailed out to avert failure, such as Bear Stearns, Lehman Brothers, Wachovia, and Washington Mutual, were either BHCs or large investment banking institutions that experienced the same vulnerabilities as banks, such as a "run" on their assets. AIG is an insurance company whose activities closely mirrored those of these large banks. The banks that were most damaged had all invested heavily in the subprime housing market. Some were over-leveraged, and their risks and vulnerabilities were not diversified.

343. James Rowley & Nicholas Johnston, *Bailout Bill Sent Back to House After Senate Passage*, BLOOMBERG (Oct. 2, 2008, 8:24 AM), http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aFnvkteaver8; Ronald D. Orol, *Treasury, Fed unveil $1.5 trillion rescue plan*, MARKETWATCH (Feb. 10, 2009, 4:27 PM), http://www.marketwatch.com/story/treasury-fed-unveil-15-trillion-rescue; Deborah Solomon, *Market Pans Bank Rescue Plan* WALL ST. J., Feb. 11, 2009, at A1.

344. Landon Thomas Jr., *JPMorgan and Fed Move to Bail Out Bear Stearns*, N.Y. TIMES (Mar. 14, 2008), http://www.nytimes.com/2008/03/14/business/14cnd-bear.html.

345. Cassidy, *supra* note 310, at 62.

346. Many investment banks whose activities are financial in nature and based on short-term liabilities are structured such that they are susceptible to runs. These firms are much like banks, but are not regulated like banks and are not supported by the FDIC. But as seen in the recent crisis, many were bailed out by the Federal Reserve. For an analysis of

eral Reserve was forced to step in and stabilize the firm through a capital infusion and forced sale.[347] But, perhaps this stabilizing force could have been a commercial parent or affiliate with more stable assets and revenue. As opposed to a commercial owner, a traditional BHC rarely has its own assets and makes little to no contribution to the bank.[348] Thus, holding companies have a very limited ability to save an ailing bank and are often nothing more than bystanders when their subsidiaries are in trouble. In fact, George Sutton testified in Congress that he could

> recall only a few instances when the holding company made any difference in the fate of its subsidiary bank. In almost every case, the holding company had no ability to rescue the failing bank and was nothing more than a bystander. In contrast, diversified holding companies can make real contributions to their bank subsidiaries.[349]

An example of a typical BHC structure is Citigroup. With more than 200 subsidiaries that participate in BHC Act-sanctioned financial activities such as banking and insurance, Citigroup, the BHC parent, is a shell that depends on the revenue of its many subsidiaries.[350] When the subsidiaries are troubled, the parent cannot aid them. Thus, as the banking industry has come under intense credit pressure, Citigroup is struggling to keep its head above water.[351]

Commercial firms, such as Wal-Mart, on the other hand, have a diversified business plan not dependent on the revenue from a banking subsidiary. Banks and retail companies operate differently. Banks have illiquid assets (loans) and highly liquid liabilities (deposits), which make them susceptible to runs.[352] Furthermore, they are at the center of the economy's payment system and thus have constant relationships and entanglements with other banks, exposing them to losses at each other's hands. It is easy to see how a contagion, such as troubled mortgage-backed securities, can topple an entire financial system. On the other hand, retail companies operate through medium- and long-term debt and are not collateralized by assets that can lose their value quickly. Even troubled commercial or industrial companies slide slowly into bankruptcy. In contrast, in September 2008, Lehman Brothers went bankrupt in a matter of

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the "run" on investment banks that recently occurred, *see generally* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183 (2009).

347. Cassidy, *supra* note 310, at 49.

348. Sutton Testimony, *supra* note 23, at 52.

349. *Id.* at 207.

350. Major Financial Institutions, www.swlearning.com/pdfs/chapter/0324024207_3.PDF at 48.

351. *See* Eric Dash, *U.S. Is Said to Agree to Raise Stakes in Citigroup*, N.Y. TIMES, Feb. 27, 2009, at A1.

352. The Financial Dictionary defines a bank "run" as follows: "A series of unexpected cash withdrawals caused by a sudden decline in depositor confidence or fear that the bank will be closed by the chartering agency, i.e. many depositors withdraw cash almost simultaneously. Since the cash reserve a bank keeps on hand is only a small fraction of its deposits, a large number of withdrawals in a short period of time can deplete available cash and force the bank to close and possibly go out of business." FINANCIAL DICTIONARY, http://financial-dictionary.thefreedictionary.com/Run+on+the+bank (last visited May 25, 2010).

days once it lost the confidence of clients and creditors.[353] The Federal Reserve could not stop this giant firm from falling, and some claim that the fall of Lehman Brothers was the straw that broke the back of our financial system—in a matter of days.[354] On the other hand, the U.S. automakers have grappled with financial difficulties for years and are close to, or have already declared, bankruptcy.[355] However, they have assets of significant value, and their distress has not had the tremendously damaging effect on U.S. and world markets that Lehman Brothers' collapse caused.

Commercial companies can encounter problems, but these are largely unrelated to the problems of the financial community, though commercial companies can be affected when the financial system is damaged.[356] The assets of Ford Motor Company, for example, will not disappear as quickly as those of Lehman Brothers or Bear Stearns did. Ford will not suffer a "run" on its assets. They have and will struggle to balance their assets with their liabilities for months or years without a sudden unexpected collapse. Wal-Mart, for example, reported an annual revenue of $404 billion dollars for 2009.[357] A healthy firm, such as Wal-Mart, on even a troubled automaker, can serve as a stable source of capital when a sudden collapse has shaken a financial system. As the recent crisis demonstrates, government regulation and oversight does not ensure safety,[358] but a stable source of capital always will. A commercial firm is still vulnerable to systemic shocks, but diversifying the sources of capital in a financial system can lower the risks most banks and investment firms face when the market suddenly sours.

With the nation's banks on the brink, the federal government has served as a stopgap to prevent (or delay) collapse. There is another solution. Stable commercial entities can step in to stop the hemorrhaging of our nation's banks. In the short term, failing banks can be converted into ILCs and sold to commercial firms who can revive them, thereby avoiding bank liquidations or expensive government intervention.[359] In the

353. Cassidy, *supra* note 311, at 49.

354. James Surowiecki, *Hazardous Materials?*, THE NEW YORKER, Feb. 9, 2009, at 40.

355. Bill Vlasic & Nick Bunkley, *Automakers Fear a New Normal of Low Sales*, N.Y. TIMES, Jan. 6, 2009 at B1; Jim Rutenberg & Bill Vlasic, *Chrysler Files for Bankruptcy; UAW and Fiat to take Control*, N.Y. TIMES, May 1, 2009, at A1.

356. *See* Stephanie Rosenbloom, *Sales Fall Sharply for Retailers Not Named Wal-Mart*, N.Y. TIMES, Feb. 6, 2009, at B3.

357. *Wal-Mart*, WIKIPEDIA, http://en.wikipedia.org/wiki/Wal-Mart (last visited Aug. 10, 2010).

358. There is a lot of finger pointing among policymakers as to which regulator is to blame. The Federal Reserve has blamed the SEC's inadequate governing of the major investment banks through their Consolidated Supervised Entities (CSE) program, and the Office of the Comptroller of the Currency (OCC) and FDIC have also been blamed. *See* John Sandman, *CSE Program A Failed Experiment*, SEC. TECH. MONITOR, Jan. 19, 2009, at 4. Unfortunately, as we have seen in the past, lawmakers will most likely respond to the crisis with added regulation that may increase oversight or activities restrictions, but will also likely miss the mark.

359. The FDIC has already shown a desire and willingness to allow private non-BHC investors to buy and help aid failing banks. In August of 2009, the FDIC launched a pro-

long-term, policymakers should use the successful ILC model as a guide as they begin to reshape banking in the following months and years.[360]

With respect to ILCs, most of their holding companies are many times larger than their ILC subsidiaries and could rescue their ILCs from even catastrophic losses that would otherwise debilitate a freestanding bank. "Nothing in the Federal Reserve's array of powers can protect against a bank's failure better than a capital maintenance agreement with a diversified parent" of a banking subsidiary.[361] The ILC model has demonstrated how a commercial firm can serve as a backup source of liquidity to prevent a bank from collapsing. When ILCs encounter problems, their large commercial parents can infuse capital into the banks in a matter of hours, thereby stabilizing them and allowing them to function through a threatening credit shortage that would debilitate an unaffiliated commercial bank.[362]

A practical criticism for allowing more integration between commerce and banking is that while Wal-Mart and other commercial firms may know about the retail or auto business, their market dominance and superiority does not encompass banking.[363] In other words, Wal-Mart is good at retail, but what does it know about banking? This criticism assumes that the same people that run the retail operation would also run the bank. However, that management structure is impermissible under state charter restrictions.[364] Utah, for example, requires that the management executives of all ILCs have extensive bank management experience.[365] The state charter also requires that the board of directors be comprised of a majority of independent members.[366] Al D. Melina, for example, was a top executive at Bank of America, a BHC, for over twenty years before he began managing GMAC's ILC.[367] BMW's ILC chairman has been in

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gram to invite private equity firms to buy and control banks without being subject to BHC Act restrictions. *See* FDIC, FINAL STATEMENT OF POLICY ON QUALIFICATIONS FOR FAILED BANK ACQUISITIONS (2009), *available at* www.fdic.gov/news/board/Aug26no2.pdf; *see also* Carl Gutierrez, *FDIC Gives Private Equity a Break*, FORBES (Aug. 26, 2009 6:30 PM), http://www.forbes.com/2009/08/26/fdic-bair-banking-markets-equities-private-equity.html.

360. Ben Bernanke, in an address to Chicago Federal Reserve, said, "Looking forward, the Federal Reserve, other regulators, and the Congress must evaluate what we have learned from the recent [sub-prime mortgage crisis] and decide what additional regulation or oversight may be needed to prevent a recurrence." Ben Bernanke, Chairman, Fed. Reserve, Special Address at the Federal Reserve Bank of Chicago 43rd Annual Conference on Bank Structure and Competition: Subprime Mortgage Market 5 (May 2007) (on file with author).

361. Sutton Testimony, *supra* note 23, at 207.

362. George Sutton gave an example of Morgan Stanley's ILC asking for and receiving a $130 million dollar capital infusion overnight. Telephone Interview with George Sutton (Jan. 7, 2009).

363. *See* ICBA Testimony, *supra* note 176.

364. These requirements are outlined in Utah's Department of Financial Institutions website at www.dfi.utah.gov/FinInst.htm.

365. *Id.*

366. *Id.*

367. Telephone Interview with Darryle Rude, *supra* note 316.

the banking industry for over twenty-five years.[368] For many of the companies that own ILCs, including GMAC, BMW, Ford, and Target, lending is not a new business. Target launched the first in-store credit card over one hundred years ago in their Dayton Hudson store and has operated Target National Bank, which was grandfathered in through CEBA, for over fifteen years.[369]

A potential risk in expanding the ILC model would be that the ILC subsidiary would become a larger entity than the commercial firm above it and control the business such that the commercial firm could not serve as a backup source of liquidity for the bank. This structure would resemble a typical bank holding company, but with the added risk that the FDIC would be forced to step in and bail out the commercial parent. However, this structure can be impeded by regulation, and it does not pose more of a risk to the banking system than the current BHC structure.

B. Economic Benefits

In addition to a general stabilizing effect, studies have shown that there are also benefits to the broader economy when banking and commerce are allowed to mix.[370] Bank diversification reduces operating costs and can result in more efficient management of different financial transactions.[371] Achieving a lower cost of production by increasing the scale of production is referred to as economies of scale.[372] Reducing costs by coordinating various products within one organization is referred to as economies of scope.[373] Thomas Huertas states:

> Financial services are particularly likely to be characterized by economies of scope, for information is a key factor in the production of financial services. . . . For example, many of the same data needed to grant a mortgage can be used to sell homeowner's insurance. The firm that offers both services need collect the information only once and can pass the resultant cost savings along to the consumer.[374]

Huertas argues that the mixing of banking and commerce would eliminate the market power that our current financial system confers on finan-

368. *Id.*

369. *Id.*

370. *See, e.g.*, Huertas, *supra* note 1, at 743–62; FDIC, Mandate for Change, *supra* note 140, at 283.

371. *See generally*, FDIC, Mandate for Change, *supra* note 140, at 2; Raskovich, *supra* note 44; Huertas, *supra* note 1.

372. *See Economies of Scale Definition*, The Linux Information Project, http://www.linfo.org/economies_of_Scale.html (last visited July 22, 2010).

373. Economies of scope arise when a factor needed to produce one product can be used at little or no additional cost to produce another. This means that a firm that produces the two products jointly can do so more cheaply than two independent firms that produce the two products separately. Customers therefore get a lower price on one or both of the two products, and firms that produce the products jointly tend to gain market share at the expense of firms that produce the products separately. Huertas, *supra* note 1, at 746–47.

374. Huertas, *supra* note 1, at 747.

cial firms and that the increased competition would allow financial firms to develop more comprehensive financial services that would result in improved convenience and reduced prices.[375] He also demonstrates that limits on entry into any sector increases transaction costs and service fees.[376]

A relevant study analyzed the success of banks that entered a market through a Wal-Mart store compared with banks that entered a market in other ways.[377] The study found that banks located within Wal-Mart stores, though not owned by Wal-Mart, experience more rapid growth in deposits.[378] This study suggests that the "one-stop shopping" approach to banking could lead to increased market efficiencies.

Another study used corporate tax returns to conclude that bank holding companies could double their average return on assets, without any increase in risk, by investing in the following diversified portfolio: "55% asset value in banking, 14% in retail, 13% in non-bank financial services, 8% in wholesale, and 6% in construction."[379] The study concludes that increasing returns could have been accomplished with minimum risk by combining banks with one of the construction, retail, or wholesale sectors and that the potential benefits from banking diversification appear to be quite significant.[380]

Although the United States is one of the most restrictive banking regimes in the world and has limited data on the effects of mixing banking and commerce, studies done abroad clearly demonstrate the economic benefits of this mixture.[381] In the United Kingdom (UK) and the EU, for example, most commercial firms, including United States firms, own banks because there is no prohibition against a commercial firm owning a bank.[382] The EU defines a bank widely as "an institution that grants credit for its own account and receives deposits . . . from the public, and has a banking license . . . ."[383]

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375. *Id.*

376. "[L]imits on entry into investment banking tend to raise the underwriting fees that issuers must pay to float new securities." *Id.* at 746.

377. ROBERT M. ADAMS ET AL., *The Value of Location in Bank Competition: Examining the Effect of Wal-Mart Branches*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 84, 84 (demonstrating that Wal-Mart bank branches are a complement to and are benefited by relationship to Wal-Mart and that it is the existing distribution channel that makes the in-store locations valuable).

378. *Id.* at 88.

379. *Id.* (citing Larry D. Wall et al., The Last Frontier: The Integration of Banking and Commerce in the U.S. 49 (May 2007) (unpublished manuscript) (on file with Financial Management Association International)); Raskovich, *supra* note 44, at 9.

380. Wall et al., *supra* note 379, at 22, 39.

381. *See generally* Barth et al., *supra* note 174; João A.C. Santos, *Banking and Commerce: How Does the United States Compare to Other Countries?*, 34 FED. RES. BANK OF CLEVELAND ECON. REV. 14, 18–23 (1997).

382. HUERTAS, *supra* note 256, at 64. The examples include GE and GE Credit, which own various banks in several member states; Ford Motor and Ford Motor Credit, which owns Ford Credit Europe Bank (UK); E-Bay/PayPal, which owns PayPal Bank (Luxembourg); Volkswagen, VW Bank (Germany); and Sainsbury, which own Sainsbury's Bank (UK).

383. *Id.* at 61.

Although many of these studies were conducted before the current financial crisis, which has largely reshaped banking, their findings are still persuasive. A number of studies conducted on banks in Japan and Germany indicate that where commerce and banking are not separated, informational efficiencies lead to reduced transaction costs in doing business.[384] A few studies have shown that distressed commercial firms with banking affiliates have performed better and overcome insolvency sooner than those without affiliations, resulting in lower financial distress for the firm as well as lower costs.[385] Studies conducted in the United States have found that firms affiliated with banks perform better during reconstruction following bankruptcy than unaffiliated firms.[386] And other studies have shown the positive effects of bankers being on the boards of commercial firms.[387]

When banks and commercial firms have a close relationship, there is a better assessment of risk. In Germany, firms held by banks performed better than those not affiliated with banks.[388] In the U.S. system, where banks are not allowed to affiliate with commercial firms, a problem of "asymmetric information" arises, which can result in increased expenses. A recent study examining the effect of informational asymmetries on the pricing and maturity of private debt contracts found that information asymmetries increase the costs of debt capital and decrease loan maturities in both private and public markets.[389] Banks must engage in a time-consuming and costly due diligence process to gather information on borrowers before issuing credit. While this process is useful and necessary, any reduction in these expenses would lower the cost of capital. Studies have shown that in countries where commercial entities and banks are more integrated, higher levels of information sharing has led to lower costs of capital and transaction costs.[390]

A recent cross-country study looked at how the mixing of banking and commerce would affect loan pricing and found that integration could lead to better loan terms because of stronger lender-borrower relationships and informational advantages that could lead to more efficient monitoring.[391] Another study determined that "small business borrowers with longer banking relationships tend to pay lower interest rates and are less

384. Haubrich & Santos, *supra* note 3, at 123.

385. *See* Santos, *supra* note 381, at 23.

386. Barth et al., *supra* note 174, at 1210–11.

387. João A.C. Santos & Adrienne S. Rumble, *The American Keiretsu and Universal Banks: Investing, Voting and Sitting on Nonfinancials' Corporate Boards*, 80 J. FIN. ECON. 419, 422 (2006).

388. Haubrich & Santos, *supra* note 3, at 123.

389. REGINA WITTENBERG-MOERMAN, *The Impact of Information Asymmetry on Debt Pricing and Maturity Presentation*, *in* THE MIXING OF BANKING & COMMERCE, *supra* note 157, at 123, 135.

390. Raskovich, *supra* note 44, at 12.

391. Li Hao et al., *Effect of Bank Regulation and Lender Location on Loan Spreads* (Working Paper 2009), *available at* http://ssrn.com/abstract=775027.

likely to pledge collateral,"[392] further demonstrating that informational efficiencies lead to reduced transaction costs. When banks have access to more information, they can more accurately price for risk and pass on a lower interest rate to the borrower.[393] Through an ongoing lending relationship, a bank can obtain more accurate information about a firm's credit risk. In turn, this can lead to a better valuation of a firm and limit over pricing or underpricing, which is damaging to capital markets. A 2004 study found that "under-pricing is [about 17%] less severe for IPOs managed by banks that have a pre-IPO relationship with the firm going public."[394]

A comprehensive study conducted on banks across the world found no positive effects "from restricting the mixing of banking and commerce."[395] In fact, the study found that "restricting the mixing of banking and commerce is associated with *greater* financial fragility."[396] The "empirical results highlight the negative implications of imposing restrictions on the activities of commercial banks" and found "no countervailing positive benefits from restricting the mixing of banking and commerce."[397]

It is problematic to apply international studies to the United States' financial system because the United States' banking system is much larger and more complex than other financial systems, but the studies do show that where commerce and banking have mixed, the results have been positive.[398] In addition, many of these findings have been weakened as banks across the world, including those that were diversified, are now in severe distress.

Thomas Huertas, advocating the mixing of banking and commerce in the United States, states that "technology and market developments are blurring the distinction between banks and non-banks."[399] Huertas argues that the American system needs to catch up to the advances in the financial markets.[400] Many commercial firms in America already participate in banking activities through commercial paper and private placements. Many sources of credit and investments in commercial firms are

392. Raskovich, *supra* note 44, at 13; Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351, 353 (1995).

393. Berger & Udell, *supra* note 392, at 363.

394. Raskovich, *supra* note 44, at 14; Carola Schenone, *The Effect of Banking Relationships on the Firm's IPO Underpricing*, 59 J. FIN. 2903, 2905 (2004).

395. JAMES R. BARTH ET AL., *Banking Systems Around the Globe: Do Regulation and Ownership Affect Performance and Stability?*, *in* PRUDENTIAL SUPERVISION: WHAT WORKS AND WHAT DOESN'T 31, 35 (Frederic S. Mishkin ed., 2001).

396. *Id.* at 10.

397. *Id.* at 3, 11.

398. *See supra* notes 381–90 and accompanying text.

399. Darwish & Evanoff, *supra* note 273, at 3. In 1997, Chairman Greenspan addressed such developments as follows: "The world is changing rapidly and it may well become increasingly difficult to distinguish between banking and aspects of commerce." *The Financial Services Competitiveness Act of 1997: Hearing on H.R. 10 Before the H. Comm. on Banking and Financial Servs.*, 105th Cong. 5 (1997) (statement of Alan Greenspan, Chairman of the Federal Reserve).

400. Huertas, *supra* note 382, at 61.

essentially identical to banking activities.[401] PayPal Inc., for example, is a commercial enterprise that has over one hundred million consumers and firms in over fifty countries.[402] PayPal issues accounts that "enable [a] holder to send and receive payments, hold balances (that may be invested in a money market mutual fund) and withdraw cash from ATMs."[403] "Mobile-phone companies issue pre-paid cards that [customers can use] to pay for telecom's services and, increasingly, offer other goods and services as well."[404] Other businesses that previously did not intersect with banking have now developed financing arms in order to better serve customers and expand their reach. One example is UPS Capital, which provides financing for small businesses developing their supply chain.[405] UPS is just one example of a company that has found greater efficiency and an increased capacity to meet customer demand by engaging in banking activities. Thus, commercial firms are already engaged in offering credit and accepting deposits—activities that were previously the domain of commercial banks. And they are doing so because the global market seems to demand and reward more comprehensive business solutions and services.[406]

Just as businesses are increasing efficiency by providing financing, research has also demonstrated that when banks are integrated and their operations diversified, they are less likely to take risks.[407] One study of the benefits of mixing and commerce concludes that "permit[ing] vertical integration between banks and commercial firms . . . would tend to raise bank profits while advancing economic efficiency by improving coordination between banks and commercial borrowers."[408] It is unlikely that risk can be eliminated from banking, and it is possible that commercial firms entering banking would introduce new and unforeseen risks as these partnerships were allowed to expand. Nevertheless, there is a body of research that seems to support the proposition that allowing commercial firm ownership of ILCs could lead to increased stability and efficiency.[409]

For the last several decades, ILCs with commercial parents have been a small, controlled arena to test the effects of mixing banking and com-

401. *Id.* at 62.
402. *Id.*
403. *Id.* Huertas notes that cash withdrawals at ATMs are only allowed at certain locations.
404. *Id.*
405. FRIEDMAN, *supra* note 266, at 173 ("UPS was doing business with a small biotech company in Canada . . . [that was having a] problem keeping up with demand and could not get financing. . . . UPS redesigned the company's system based around a refrigerator hub in Dallas and extended it financing through UPS Capital. The result . . . was less inventory, better cash flow, better customer service—and an embedded customer for UPS.").
406. *Id.* at 149–50. Thomas Friedman explains how "insourcing" and outsourcing have caused many companies to service clients on several levels. *Id.* He focuses on UPS's financing arm to demonstrate how this company is expanding its services to take more companies from small to global enterprises. *Id.*
407. *Id.* at 4–6.
408. Raskovich, *supra* note 44, at 11.
409. *See supra* notes 370–87 and accompanying text.

merce, and they have proven safe. When analyzing the S&L debacle of the 1980s, a banking scholar noted: "[T]hese facts, at a minimum, support the conclusion that any correlation between 'commercial' control of a bank and safety-and-soundness is strongly positive."[410] The ILC sector has also demonstrated this point. Problems at commercial-affiliated institutions have been very rare, and the FDIC fund has not borne losses.[411]

C. UTAH ILCs

Utah, home to most of the nation's ILCs, has been an effective regulator, and the many ILCs thriving in the state have shown that commerce and banking can indeed mix with positive results and without heightened risk. William M. Isaac, the former chairman of the FDIC, speaking on ILCs stated that "those who would restrict its operation should bear a significant burden of demonstrating the need for the restrictions . . . . Putting the Wal-Mart issue aside, there is not a thing wrong with the ILC industry or its regulation."[412]

As mentioned previously, no commercially owned ILC failure has caused a single dollar of loss to the FDIC insurance fund, and no Utah-based ILC (commercial or not) has ever failed.[413] Moreover, an FDIC study states that there are three variables affecting the probability of insolvency: the level of the capital–asset ratio, the level of returns, and the variability of returns.[414] The higher the capital-asset ratio and the level of returns; on average, the lower the probability of failure is.[415] Utah ILCs rank higher on all of these levels, on average, compared to most other states.[416] An analysis of banking figures released September 30, 2008, for state-chartered banks across the United States demonstrates that ILCs have higher capital–asset ratios and lower risk than most other state-chartered banks.[417] Thus, Utah ILCs are among the healthiest banks in the country. Although several of the twenty-seven Utah ILCs lost money in 2008 and 2009, they remain well-capitalized overall and have good asset quality.[418]

In addition to being well-capitalized and well-managed, the ILC industry makes important contributions to consumers with very minimal

410. MUCKENFUSS & EAGER, *supra* note 157, at 46.

411. *See supra* notes 381–402 and accompanying text.

412. William M. Isaac, *Wal-Mart Issue No Reason to Hobble ILC Industry*, AM. BANKER, Mar. 13, 2007, at 1.

413. Leary Testimony, *supra* note 19, at 7.

414. *See* FDIC, MANDATE FOR CHANGE, *supra* note 140, at 61.

415. *Id.*

416. I compare the capital ratios of Utah to other states for third quarter 2008. Eighty percent of Utah's state-chartered banks are ILCs, so the Utah statistics are a good indicator for the entire ILC industry. State figures are available at FDIC State Profiles 2008, FDIC, http://www.fdic.gov/bank/analytical/stateprofile/index.html (last visited July 24, 2010).

417. *Id.*

418. Telephone Interview with Darryle Rude, *supra* note 316.

risk.[419] In the history of ILCs, only two ILCs with parent companies have failed, and their parent companies were not commercial firms but financial corporations.[420] It is noteworthy that these holding companies were financial companies and not commercial firms. These two failures cost the FDIC about $100 million and as John Douglas observes:

> Both failed not as a result of any self dealing, conflicts of interest or impropriety by their corporate owners; rather, they failed the "old fashioned way"—poor risk diversification, imprudent lending and poor controls. These two failures stand in sharp contrast to the hundreds of bank failures that operated in holding company structures, many of which cost the FDIC billions of dollars.[421]

The strength of Utah ILCs has to do with its sophisticated regulatory scheme and the diverse holding companies that own Utah ILCs. The regulatory organizations have responded to potential failures on a number of occasions and helped ailing firms.[422] It is the nature of ILCs that causes their success—they can receive capital very quickly, literally overnight, from their well-funded parents when they encounter problems. This easy access to capital cannot be understated, as it is the most important factor for bank safety. An ILC also benefits from its business relationship with the parent. There are no marketing costs associated with ILCs because their business is often handed to them from their parent company. Most parents organize industrial banks to add value to an existing business, and as a result, the banks begin as profitable enterprises with few start-up costs and pitfalls.[423] Most traditional banks only achieve this level of security and development after many years in operation.

V. CONCLUSION

On February 25, 2009, President Obama, addressing the financial regulatory system, stated, "we can no longer sustain . . . 21st century markets

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419. *See generally ILCs—A Review of Charter, Ownership, and Supervision Issues*, *supra* note 30, at 55 (testimony of John L. Douglas on behalf of the American Financial Services Association (AFSA).

420. The two institutions were Pacific Thrift and Loan and Security Pacific Bank. *See* Press Release, Fed. Deposit Ins. Corp., FDIC Approves the Assumption of the Insured Deposits of Pacific Thrift and Loan Company, Woodland Hills, California (Nov. 19, 1999), *available at* http://www.fdic.gov/news/news/press/1999/pr9971.html); Press Release, Fed. Deposit Ins. Corp., Pacific Western Bank Acquires All the Deposits of Security Pacific Bank, Los Angeles, California, (Nov. 7, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08114.html; *see also ILCs—A Review of Charter, Ownership, and Supervision Issues*, *supra* note 307, at 100 n.20. Between 1986 and 1996, there were a series of ILC failures, due to the California banking crisis. None of the failed banks had a commercial parent nor were they part of a larger holding company structure. According to the FDIC, they failed from "ineffective risk management and poor credit quality." *Id.; see also* West, *supra* note 9, at 6.

421. *ILCs—A Review of Charter, Ownership, and Supervision Issues*, *supra* note 307, at 100 (testimony of John L. Douglas on behalf of the American Financial services Association).

422. Telephone Interview with Darryle Rude, *supra* note 316.

423. Sutton Testimony, *supra* note 23, at 52.

with 20th century regulations."[424] Policymakers should reconsider regulation that bans the relationship between commerce and banking and should usher in a more open financial system through a new regulatory structure that acknowledges the advances of the last several decades. Such openness between banking and commerce will require a new system of comprehensive oversight, which can be modeled after the successful ILC regulatory structure.

The ILC has filled a much-needed role in the intersection between banking and commerce for many years and has met the market's demand for flexibility in banking. In addition, the current economic crisis has illustrated the danger of a non-diversified banking system. The ILC structure is currently the only place where the stabilizing relationship between commerce and banking takes place and, as demonstrated, the small industry has remained sound through a systemic financial collapse largely due to its commercial relationships.

424. Caren Bohan & Jeff Mason, *Obama urges quick action on Wall Street reform*, USA TODAY (Feb. 27, 2009, 1:08 PM), http://www.usatoday.com/money/companies/regulation/2009-02-25-obama-wall-street-reforms_N.htm.