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Wal-Mart and the Separation of Banking and Commerce

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During 2005–2006, Wal-Mart, Home Depot, and several other commercial firms applied to the Federal Deposit Insurance Corporation (FDIC) for permission to acquire FDIC-insured industrial loan companies (ILCs). Those applications were opposed by business groups, labor unions, community activists, and members of Congress. In January 2007, the FDIC imposed a one-year moratorium on all acquisitions of ILCs by commercial firms and asked Congress to determine whether such acquisitions should be prohibited.

As the FDIC noted, acquisitions of ILCs by commercial firms raise three important policy issues, which are addressed in this Article. First, commercial ownership of ILCs conflicts with the policy of separating banking and commerce, which has been generally followed in the United States since 1787 and has gained strength over time. Banks have frequently tried to engage in commercial activities, and commercial firms have often attempted to gain control of banks. However, federal and state legislators have repeatedly passed laws to separate banking and commerce when it appeared that either (i) the involvement of banks in commercial activities threatened their safety and soundness, or (ii) commercial firms were acquiring large numbers of banks. ILCs represent the last remaining exception to the policy of prohibiting commercial ownership of banks.

Second, acquisitions of ILCs by commercial firms will produce serious risks for our nation's financial system and economy. Commercially-owned ILCs will extend federal safety net subsidies to the commercial sector, and ILCs will have strong incentives to make loans and investments that benefit their commercial affiliates. Commercial ownership of ILCs therefore creates a competitive imbalance between commercial firms that own ILCs and those that do not. Commercially-owned ILCs are also vulnerable to contagious losses of confidence resulting from problems at their parent companies. Accordingly, federal regulators may feel compelled to arrange "too big to fail" bailouts of large troubled parent companies of ILCs.

Third, the FDIC does not have authority to exercise consolidated supervision over commercial owners of ILCs. Any grant of such authority to the FDIC would have adverse consequences. Mandating FDIC supervision of commercial parent companies would significantly increase the federal government's interference in the general economy. FDIC supervision of commercial owners could also impair market discipline by causing market participants to expect FDIC support for such owners during financial crises. For all these reasons, Congress should prohibit further acquisitions of ILCs by commercial firms.

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ARTHUR E. WILMARTH, JR.*

I. INTRODUCTION

In July 2005, Wal-Mart Stores, Inc. applied to the Federal Deposit Insurance Corporation (FDIC) to obtain federal deposit insurance for a proposed industrial bank, which would be named "Wal-Mart Bank" and would be chartered under Utah law. As described in Part II.A of this Article, the primary activity of the proposed Wal-Mart Bank would be to act as a sponsor for the processing and settlement of credit card payments, debit card payments, and check payments made by customers at Wal-Mart

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* Professor of Law, George Washington University Law School. I would like to thank Anna Gelpern, Patricia McCoy, and participants in the *Wal-Mart Matters* symposium sponsored by the University of Connecticut School of Law in October 2006, for their helpful comments on a preliminary version of this Article. I would also like to thank Germaine Leahy, Head of Reference in the Jacob Burns Law Library, for her excellent research assistance. Unless otherwise indicated, this Article includes developments through February 26, 2007.

On March 16, 2007, Wal-Mart Stores, Inc. announced that it was withdrawing its application to the Federal Deposit Insurance Corporation and the Utah Department of Financial Institutions for a federally-insured industrial bank. *See* Eric Dash, *Wal-Mart Abandons Bank Plans*, N.Y. TIMES, Mar. 17, 2007, at C1, *available at* LEXIS, News Library, NYT File. At the time of Wal-Mart's announcement, this Article was already in the editorial process, and it was therefore not feasible to revise the Article. For two reasons, however, Wal-Mart's decision does not change the Article's purpose or analysis.

First, Wal-Mart evidently has not abandoned its plans to enter the banking business. At the time Wal-Mart withdrew its application, Wal-Mart said that it was not giving up its plans to expand its limited menu of consumer financial services to include products such as home mortgages, home equity lines of credit, other consumer loans and investment products. Wal-Mart stated that it intends to offer such products in conjunction with financial service companies that are its "partners." *Id.*; *see also* Rob Blackwell, *Post ILC, Wal-Mart Discusses Strategy*, AM. BANKER, Mar. 19, 2007, at 1, *available at* LEXIS, News Library, AMBNKR File. It appears that Wal-Mart withdrew its application because it concluded that the application (and the widespread opposition thereto) increased the likelihood that Congress would pass legislation to prohibit acquisitions of industrial banks by commercial firms. *See* Blackwell, *supra*; Eric Dash, *Wal-Mart's Bank Plans Questioned*, N.Y. TIMES, Mar. 15, 2007, at C1, *available at* LEXIS, News Library, NYT File. Wal-Mart therefore may have withdrawn its application in order to forestall an immediate threat of adverse legislation. In a subsequent interview, Wal-Mart's president, H. Lee Scott Jr., indicated that Wal-Mart had not given up the idea of acquiring an industrial bank. Mr. Scott said that "[w]e are looking at how can we get another bite of that apple," and he also replied, "Oh, no," when asked whether the possibility of an industrial bank charter was a "dead issue" for Wal-Mart. Joe Adler, *In Brief: Banking Still on Wal-Mart's Agenda*, AM. BANKER, Mar. 29, 2007, at 20, *available at* LEXIS, News Library, AMBNKR File (reporting on an interview of Mr. Scott on Fox News).

Second, despite Wal-Mart's withdrawal of its application, several other commercial firms, including Home Depot, still have pending applications to acquire industrial banks and plan to pursue those applications. Thus, the question of whether further acquisitions of industrial banks by commercial firms are consistent with the best interests of our financial system and our national economy remains a significant issue for Congress to resolve. *See* Blackwell, *supra*.

stores. In addition, Wal-Mart Bank would offer certificates of deposit to charitable organizations and to individuals through deposit brokers.

Wal-Mart declared that Wal-Mart Bank would not open any branches or deal directly with the public. Nevertheless, if Wal-Mart's application had been approved, the world's largest retailer would have owned an FDIC-insured depository institution with powers equal to those of commercial banks (except for the ability to offer checking accounts payable on demand). In view of Wal-Mart's past efforts to acquire full-service depository institutions, many commentators predicted that Wal-Mart's proposed industrial bank would eventually seek to open branches in Wal-Mart stores and to exercise the full range of financial services authorized by its Utah charter.

Wal-Mart's application provoked intense opposition from a broad coalition consisting of community bankers, officials of the Federal Reserve Board (FRB), labor unions, retail stores, community activists, and members of Congress. Wal-Mart's opponents advanced numerous arguments, including the claim that a major commercial firm should not be permitted to acquire an FDIC-insured institution. In July 2006, as discussed in Part II.B, the FDIC responded to this widespread opposition by placing a six-month moratorium on Wal-Mart's application and all other pending applications to obtain federal deposit insurance for industrial banks or industrial loan companies (ILCs).[1] Shortly thereafter, the FDIC invited the public to comment on twelve policy issues related to acquisitions of ILCs by commercial (i.e., non-financial) companies.[2]

In December 2006, more than a hundred members of Congress asked the FDIC to extend its moratorium so that Congress could consider proposed legislation that would prohibit commercial firms from acquiring ILCs.[3] On January 31, 2007, the FDIC extended its moratorium for an additional year with respect to pending applications by Wal-Mart, Home Depot and other commercial firms to acquire control of ILCs. At the same time, the FDIC lifted its moratorium with regard to pending applications by financial companies or individuals to acquire ILCs. The FDIC decided to extend its moratorium on acquisitions of ILCs by commercial firms because (i) the FDIC determined that such acquisitions raise special policy issues, as federal law does not permit commercial firms to acquire other

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[1] For purposes of this Article, unless otherwise indicated, (1) the term "deposit insurance" means federal deposit insurance administered by the FDIC; (2) the term "ILC" includes any ILC or industrial bank that is eligible for deposit insurance; and (3) the term "commerce" or "commercial" refers to companies that are primarily engaged in non-financial lines of business.

[2] Federal Deposit Insurance Corporation, Industrial Loan Companies and Industrial Banks: Notice and Request for Comment, 71 Fed. Reg. 49,456, 49,456–57 (2006) [hereinafter FDIC Request for Comment].

[3] Bernard Wysocki Jr., *On the Shelf: How Broad Coalition Stymied Wal-Mart's Bid to Own a Bank*, WALL ST. J., Oct. 23, 2006, at A1, *available at* LEXIS, News Library, WSJNL File.

types of FDIC-insured depository institutions, (ii) the FDIC believed that Congress should be given additional time to consider whether to adopt new legislation with respect to commercially-owned ILCs, and (iii) the FDIC was concerned that its current supervisory regime might not be adequate to identify and control the risks created by such institutions and their commercial affiliates.[4]

In extending its moratorium on commercial acquisitions of ILCs, the FDIC stated that the comments it received on commercially-owned ILCs raised three major questions. First, does commercial ownership of ILCs conflict with a general U.S. policy of separating banking and commerce? Second, do commercially-owned ILCs present risks to the U.S. financial system and the broader economy that are greater than the risks posed by financial holding companies? Third, does the FDIC have adequate supervisory powers to control the potential risks created by commercially-owned ILCs, despite the FDIC's lack of consolidated supervisory authority over the commercial parent companies?[5]

Part III of this Article analyzes each of the three major policy questions identified by the FDIC. Part III.A examines the history of federal and state legislation in the United States regarding the authority of banks to engage in commercial activities and the ability of commercial firms to own banks. Since the Republic's founding, banks have frequently tried to engage in commercial activities, and commercial firms have often attempted to control banks. However, legislators have generally sought to separate banks from commercial businesses. Indeed, legislators have repeatedly imposed legal restraints on bank powers and have prohibited bank affiliations with commercial firms when it appeared that either (i) the involvement of banks in commercial activities threatened their safety and soundness, or (ii) commercial firms were acquiring large numbers of banks. The policy of separating banking and commerce has gained strength during the past half-century. On four occasions since 1956, Congress has adopted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. ILCs represent the last remaining exception to the general policy prohibiting acquisitions of banks by commercial firms.

As discussed in Part III.B, there are at least three reasons why further acquisitions of ILCs by commercial firms are likely to create serious risks for our nation's financial system and general economy. First, the ownership of ILCs by large commercial firms will spread federal safety net

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[4] *See infra* notes 63–68 and accompanying text (discussing reasons for the FDIC's actions).

[5] Federal Deposit Insurance Corporation, Moratorium on Certain Industrial Bank Applications and Notices: Limited Extension of Moratorium, 72 Fed. Reg. 5290, 5291–92 (Feb. 5, 2007) [hereinafter FDIC Moratorium Extension Notice].

subsidies to the commercial sector of the economy. Second, as shown by the financial history of the United States and other nations, commercially-owned ILCs are subject to conflicts of interest that will encourage them to make loans and investments to benefit their commercial affiliates. In combination, the extension of safety net subsidies to commercial firms and preferential lending by commercially-owned ILCs will threaten the solvency of the deposit insurance system and will create a competitive imbalance between commercial firms that own ILCs and those that do not. Third, commercially-owned ILCs will be subject to contagious losses of confidence resulting from problems at their parent companies. Federal regulators will therefore be inclined to support a troubled commercial parent company whenever the failure of its subsidiary ILC might cause a significant disruption within the financial system. Consequently, commercial ownership of ILCs will increase the likelihood of federal bailouts within the commercial sector of our economy.

As explained in Part III.C, the FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs. Moreover, any decision by Congress to designate the FDIC as consolidated regulator of such firms would have at least four negative effects. First, the FDIC lacks the experience or the specialized expertise to identify and control the risks created by commercial owners of ILCs. Second, FDIC supervision of commercial owners could impair market discipline by causing market participants to expect that FDIC would support those owners during financial crises. Third, attempts by the FDIC to control the activities of commercial affiliates of ILCs would significantly increase the amount of governmental interference in the general economy. Fourth, large commercial owners of ILCs are likely to enjoy substantial political influence, which they can use to extract costly subsidies or forbearance measures from both Congress and the FDIC.

II. WAL-MART'S APPLICATION AND THE FDIC'S MORATORIUM

A. *Wal-Mart's Application for an ILC*

In July 2005, Wal-Mart applied to the Utah Department of Financial Institutions for permission to establish a wholly-owned ILC known as "Wal-Mart Bank."[6] At the same time, Wal-Mart applied to the FDIC to obtain deposit insurance for its proposed ILC.[7] Under Utah law, an ILC

[6] Ann Zimmerman, *Wal-Mart Is Trying to Establish Bank Again*, *This Time in Utah*, WALL ST. J., July 20, 2005, at C4, *available at* LEXIS, News Library, WSJNL File.

[7] Becky Yerak & Josh Noel, *Wal-Mart Plan Has Bankers on Edge*: *Applications Filed to Run Bank in Utah*, CHI. TRIB., July 20, 2005, at C1, *available at* LEXIS, News Library, CHTRIB File.

must obtain and maintain deposit insurance from the FDIC in order to conduct business.[8]

Wal-Mart's joint application to Utah and the FDIC stated that the proposed Wal-Mart Bank would engage in a very limited set of activities. Wal-Mart Bank's principal function would be to serve as the depository institution sponsor for the presentment, processing and settlement of (i) credit card payments and debit card payments made by customers at Wal-Mart stores and (ii) checks tendered by Wal-Mart customers that are electronically converted for payment through the Automated Clearing House (ACH) network. Thus, Wal-Mart Bank would provide Wal-Mart with direct access to the payments system and would enable Wal-Mart to stop paying fees to the banks that currently process payments made to Wal-Mart by its customers. Wal-Mart's application stated that Wal-Mart Bank did not "currently" propose to provide payment processing services to any person other than Wal-Mart.[9]

In addition to processing payments for Wal-Mart, the proposed Wal-Mart Bank would offer certificates of deposit to nonprofit charitable and educational organizations and to individuals through deposit brokers. However, Wal-Mart declared that Wal-Mart Bank would not offer any retail banking services at its main office, would not open any branches, and would not make any loans.[10]

Notwithstanding the limited scope of the proposed ILC's activities, Wal-Mart's application triggered intense opposition from a wide spectrum of opponents, including community bankers, FRB officials, labor unions, grocery and convenience stores, community activists, and members of Congress.[11] The FDIC held three days of public hearings and received testimony from nearly seventy witnesses, most of whom opposed Wal-Mart's application.[12] The FDIC received more than 13,800 written comments on Wal-Mart's application, again mostly in opposition to the application.[13] Fifty members of Congress filed written comments opposing

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[8] UTAH CODE ANN. § 7-8-3(4)(b) (2006).

[9] Wal-Mart Bank Application, Vol. I, at 6–7 (2005) (on file with Connecticut Law Review).

[10] *Id.* at 10; Letter from Jerold G. Oldroyd, Counsel, Wal-Mart Stores, Inc., to Carol Saccomonto, FDIC San Francisco Regional Office (Mar. 30, 2006), *available at* http://www.fdic.gov/regulations/laws/walmart/walmartletters.pdf.

[11] Wysocki, *supra* note 3, at A1.

[12] *See* Wal-Mart Bank Federal Deposit Insurance Application: Public Hearings (on file with Connecticut Law Review) (providing written statements and oral testimony of witnesses) [hereinafter Wal-Mart Hearings]. By my count, of the sixty-seven witnesses who testified at the public hearings, fifty-five opposed Wal-Mart's application, nine supported the application and three were neutral (*viz.*, former Senators Jake Garn, Jim Tozzi and Michael H. Richmond).

[13] *See* Federal Deposit Insurance Corporation, Moratorium on Certain Industrial Loan Company Applications and Notices, 71 Fed. Reg. 43,482, 43,483 (Aug. 1, 2006) [hereinafter FDIC Moratorium Notice]; FDIC Moratorium Extension Notice, *supra* note 5, at 5291.

Wal-Mart's application,[14] and nearly a hundred members of Congress asked the FDIC to impose a moratorium on any consideration of Wal-Mart's application and other pending applications to acquire ILCs.[15]

Some opponents argued that the proposed Wal-Mart Bank would present a significant risk to the U.S. payments system even if its functions were limited to those set forth in Wal-Mart's application. One witness at the FDIC's public hearings warned that a large-scale failure by Wal-Mart Bank to settle payments transactions on behalf of Wal-Mart could disrupt the payments system and inflict serious losses on other financial institutions and their customers.[16] According to another witness, a large-scale default on payments by Wal-Mart Bank could create a systemic crisis because Wal-Mart currently accepts about 140 million electronic payments per month and the proposed Wal-Mart Bank would process more than $170 billion of transactions per year.[17] Another opponent argued that Wal-Mart Bank would face significant potential conflicts of interest if it became the primary processor of payments for Wal-Mart. Under current ACH rules, a bank that initiates an ACH debit transaction on behalf of a merchant must monitor the merchant's creditworthiness and also must reimburse the receiving bank if the transaction was not authorized by the receiving bank's customer.[18] The opponent claimed that Wal-Mart might conceivably pressure Wal-Mart Bank to ignore credit problems at Wal-Mart or to initiate unauthorized ACH debit transactions for the purpose of generating improper transfers of funds to Wal-Mart from receiving banks and their customers.[19] Congress expressed similar concerns about potential

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[14] *See* Letter from Jo Bonner, U.S. Congress, to Martin Gruenberg, Vice Chairman FDIC (Mar. 24, 2006) (on file with Connecticut Law Review); Letter from Artur Davis, U.S. Congress, to Martin Gruenberg, Vice Chairman, FDIC (Mar. 23, 2006) (on file with Connecticut Law Review); Letter from Byron Dorgan, U.S. Senate, to Martin Gruenberg, Acting Chairman, FDIC (Apr. 10, 2006) (on file with Connecticut Law Review); Letter from Barney Frank, U.S. Congress, to Martin Gruenberg, Acting Chairman, FDIC (Apr. 19 2006) (on file with Connecticut Law Review); Letter from Barney Frank, U.S. Congress, to Martin Gruenberg, Acting Chairman, FDIC (Apr. 26, 2006) (on file with Connecticut Law Review); Letter from Rep. James A. Leach, U.S. Congress, to Martin Gruenberg, Acting Chairman, FDIC, (Mar. 27, 2006) (on file with Connecticut Law Review); Letter from 45 Members of Congress, to Martin Gruenberg, Vice Chairman, FDIC (Mar. 16, 2006) (on file with Connecticut Law Review).

[15] Wysocki, *supra* note 3, at A1 (reporting that ninety-eight members of Congress sent a letter to the FDIC on June 8, 2006, requesting that the FDIC issue a moratorium).

[16] *See Testimony on Behalf of America's Community Bankers Before the Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 4–5 (Panel 3, Apr. 10, 2006) (written testimony of Kenneth J. Redding, President and CEO, UniBank) (on file with Connecticut Law Review).

[17] *See* Terry J. Jorde, *Written Testimony on behalf of the Independent Community Bankers of America Before the Federal Deposit Insurance* Corporation, *in* Wal-Mart Hearings, *supra* note 12, at 4 (Panel 3, Apr. 10, 2006) (on file with Connecticut Law Review).

[18] Notice of Proposed Rulemaking, 66 Fed. Reg. 18,888, 18,891 (Apr. 12, 2001).

[19] *See* Letter from Thomas M. Stevens, President, National Association of Realtors, to Sheila C. Bair, Chairman, FDIC (Oct. 10, 2006) (on file with Connecticut Law Review).

risks to the U.S. payments system when it prohibited further acquisitions of "nonbank banks" by commercial firms in 1987.[20]

Many opponents also alleged that the proposed Wal-Mart Bank, if approved by the FDIC, would eventually seek to exercise the full range of banking powers authorized by its Utah charter. Those critics pointed out that Wal-Mart had previously made three attempts to establish full-service bank branches within its stores.[21] First, Wal-Mart tried to acquire an FDIC-insured thrift institution in Oklahoma, but that acquisition was barred by Congressional legislation in 1999.[22] Second, Wal-Mart applied for permission to form a joint venture with TD Bank USA, an FDIC-insured thrift institution owned by Toronto-Dominion Bank. However, the Office of Thrift Supervision (OTS) denied Wal-Mart's application after determining that Wal-Mart's employees would be directly involved in operating the TD Bank branches that would be located in Wal-Mart's stores.[23] Third, Wal-Mart tried to acquire an ILC that was chartered under California law. However, the California legislature passed a law in 2002 that prohibited commercial firms from acquiring California-chartered ILCs.[24] In 2003, Colorado's legislature passed a similar law prohibiting acquisitions of Colorado-chartered ILCs by non-financial companies.[25]

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[20] As discussed *infra* in Part III.A.3.c, Congress passed legislation in 1987 that barred further acquisitions of "nonbank banks" (i.e., FDIC-insured banks that refrained from either accepting demand deposits or making commercial loans). The Senate committee report on that legislation declared that the "nonbank bank loophole threatens our nation's payment system by giving large diversified [commercial] firms direct access to that system." S. REP. NO. 100-19, at 10 (1987), *as reprinted in* 1987 U.S.C.C.A.N. 489, 500. The report warned that

> [a] nonbank bank cannot, as a practical matter, independently evaluate the credit of a parent or affiliate and resist that company's orders to make payments that would create overdrafts . . . [with the potential to] precipitate the failure of the nonbank bank, resulting in loss to the FDIC, the [FRB], and the nonbank bank's depositors and creditors.

Id. The report also quoted FRB chairman Paul Volcker's concern that a nonbank bank would be likely to have "token capitalization . . . relative to both the size of the parent and to the very high dollar volume of transactions [funneled] through the bank." *Id.*

[21] *See* Thomas J. Bliley, Jr., *Written Testimony on behalf of the Sound Banking Coalition Before the Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 5 (Panel 6, Apr. 10, 2006) (on file with Connecticut Law Review); Arthur C. Johnson, *Written Testimony on behalf of the American Bankers Association Before the Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 7–8 (Panel 3, Apr. 10, 2006) (on file with Connecticut Law Review); Jorde, *supra* note 17, at 5–6; Douglas S. Kantor, *Written Testimony on behalf of the National Association of Convenience Stores Before the Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 4 (Panel 6, Apr. 10, 2006) (on file with Connecticut Law Review).

[22] *See infra* notes 266–70 and accompanying text.

[23] Rob Blackwell, *Industrial Charter Could Be Wal-Mart's Way In*, AM. BANKER, Apr. 17, 2003, at 6, *available at* LEXIS, News Library, AMBNKR File; Rob Blackwell, *Wal-Mart, TD Venture Hits Regulatory Wall*, AM. BANKER, Nov. 5, 2001, at 1, *available at* LEXIS, News Library, AMBNKR File.

[24] Nicole Duran, *Nixing Wal-Mart's Bid to Buy Bank, Davis Cites GLB*, AM. BANKER, Oct. 2, 2002, at 4, *available at* LEXIS, News Library, AMBNKR File.

[25] Laura Mandaro, *In Focus: Wal-Mart's Industrial Charter Odds Look Better in Nevada*, AM. BANKER, May 9, 2003, at 1, *available at* LEXIS, News Library, AMBNKR File.

Since 2003, Wal-Mart has offered a variety of financial services to its customers in partnership with various financial institutions. For example, Wal-Mart currently offers check cashing, money orders, electronic bill payments, wire transfers, stored-value cards, and co-branded credit cards.[26] Analysts have predicted that Wal-Mart has strong incentives to expand its menu of financial services because its growth rate in traditional retailing markets has slowed in recent years.[27] In addition, Wal-Mart has often used short-term partnerships with outside providers as a way to learn how to offer new products under its own Wal-Mart brand. Thus, if Wal-Mart succeeds in acquiring its own bank, many commentators believe that Wal-Mart would want to incorporate its current offerings of financial services within that bank.[28]

The proposal by Wal-Mart Bank to offer certificates of deposit to nonprofit organizations and to individuals through deposit brokers further indicates that Wal-Mart Bank has a long-term strategy to offer retail banking services.[29] Wal-Mart Bank is not required to accept deposits from the public in order to obtain deposit insurance from the FDIC. The proposed ILC could qualify for deposit insurance simply by accepting one or more non-trust deposits in the amount of $500,000 from Wal-Mart or another affiliate.[30] Wal-Mart Bank's desire to offer deposits to the public suggests that it is seeking to lay the groundwork for a broader retail banking strategy.

In addition, it seems highly unlikely that Wal-Mart Bank would be content to pursue the very limited business plan set forth in its application over the longer term, because that plan would not generate significant

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[26] *See* Steve Cocheo, *Always Aggressive, Always Wal-Mart*, ABA BANKING J., May 2003, at 29, *available at* LEXIS, News Library, ABABJ File; Robin Sidel & Ann Zimmerman, *Can Wal-Mart Cash In on Financial Services?*, WALL ST. J., July 6, 2006, at C1, *available at* LEXIS, News Library, WSJNL File; *Supercentre Banking: Wal-Mart and Financial Services*, ECONOMIST, Sept. 3, 2005, at 65, *available at* LEXIS, News Library, ECON File.

Wal-Mart has signed leases that allow independent banks to operate branches in more than 1100 of Wal-Mart's stores. *See* Jane J. Thompson, *Written Testimony on behalf of Wal-Mart Financial Services before Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 6–7 (Panel 1, Apr. 10, 2006) (on file with Connecticut Law Review). However, former Rep. Thomas Bliley alleged that Wal-Mart could break many of those leases by paying the equivalent of a year's rent. Bliley, *supra* note 21, at 6. Another critic noted that Wal-Mart discontinued its lease programs with independent banks during 2001–2003, while it was pursuing its unsuccessful plan to operate branches in partnership with TD Bank USA. *See* Cocheo, *supra*.

[27] Cocheo, *supra* note 26; Wendy Zellner, *Your New Banker?*, BUS. WK., Feb. 7, 2005, at 29, *available at* LEXIS, News Library, BUSWK File; *see also infra* notes 398–99 and accompanying text (describing Wal-Mart's slowing growth rate in the U.S. during 2006).

[28] Cocheo, *supra* note 26; Zellner, *supra* note 27.

[29] Wal-Mart Bank Application, *supra* note 9, at 1, (discussing Wal-Mart Bank's proposal to offer certificates of deposit).

[30] *See* FDIC General Counsel's Op. No. 12, Engaged in the Business of Receiving Deposits Other Than Trust Funds, 65 Fed. Reg. 14,568, 14,568–69 (Mar. 17, 2000), *available at* http://www.fdic.gov/regulations/laws/federal/00bizdep.pdf (discussing the minimum amount of deposits that a state-chartered bank must hold in order to be "engaged in the business of receiving deposits other than trust funds" and thereby qualify to obtain deposit insurance under 12 U.S.C. § 1815(a)(1)).

profits. Jane Thompson, President of Wal-Mart Financial Services, testified that the anticipated annual revenues from Wal-Mart Bank's proposed business plan would be only $10 million during its third year of operation.[31] Given Wal-Mart's well-known focus on the bottom line, it seems improbable that Wal-Mart would choose to incur the very substantial costs it has already spent in prosecuting its application for Wal-Mart Bank if the Bank never intended to expand its operations beyond the narrow limits set forth in the application.

In November 2006, Wal-Mart's Mexican subsidiary (popularly known as Walmex) obtained approval from the Mexican Finance Ministry to organize a full-service bank in Mexico. The new bank—to be called Banco Wal-Mart de Mexico Adelante—intends to open retail branches offering deposits, loans and other financial services in hundreds of Wal-Mex stores.[32] Wal-Mart's success in obtaining a retail banking franchise in Mexico provides further support for those who claim that Wal-Mart's long-term plan is to establish a full-service banking operation in the United States.[33] Indeed, Wal-Mart's Chief Executive Officer stated in 2003 that "financial services is [an area] we would like to be in. . . . There's probably a place for us in mortgages."[34] Accordingly, this Article considers the policy issues surrounding the proposed Wal-Mart Bank based on the assumption that Wal-Mart's ILC, if approved, would eventually seek to exercise the full range of powers granted by its Utah charter.

B. *The FDIC's Moratorium on Acquisitions of ILCs by Commercial Firms*

On July 28, 2006, the FDIC imposed a six-month moratorium on the processing of Wal-Mart's application and other applications by ILCs for deposit insurance.[35] A few weeks later, the FDIC issued a request for public comment on twelve policy issues related to acquisitions of ILCs.[36] The FDIC's request for comment noted that many opponents claimed that Wal-Mart's application contravened a general U.S. policy against mixing

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[31] Thompson, , *supra* note 26, at 14.

[32] *See* Anna Gelpern, *Wal-Mart Bank in Mexico: Money to the Masses and the Home-Host Hole,* 39 CONN. L. REV. 1513 (2007); Joe Adler, *In Brief: Wal-Mart to Open Mexican Bank in '07*, AM. BANKER, Nov. 28, 2006, at 3, *available at* LEXIS, News Library, AMBNKR File; Elisabeth Malkin, *Wal-Mart Will Offer Retail Banking in Mexico, an Underserved Market*, N.Y. TIMES, Nov. 24, 2006, at C1, *available at* LEXIS, News Library, NYT File.

[33] *See* Joe Adler, *Wal-Mart Bank Discusses Branch Plan for Mexico*, AM. BANKER, Aug. 4, 2006, at 1, *available at* LEXIS, News Library, AMBNKR File (observing that "opponents of Wal-Mart's ILC application said that the Mexican initiative is another sign that the company wants to engage in retail banking here.").

[34] Abigail Goldman, *The Wal-Mart Effect: Proud to Be at the Top*, L.A. TIMES, Nov. 23, 2003, at A32, *available at* LEXIS, News Library, LAT File (quoting H. Lee Scott, Jr.).

[35] FDIC Moratorium Notice, *supra* note 13, at 43,482.

[36] FDIC Request for Comment, *supra* note 2, at 49,456–57.

banking and commerce.[37] The federal Bank Holding Company Act (BHC Act)[38] has established a general separation of banking and commerce by prohibiting commercial firms from owning FDIC-insured "banks."[39] However, the BHC Act exempts an ILC from the definition of "bank," and thereby permits a commercial firm to own an ILC, provided the ILC satisfies two criteria.[40] First, the ILC must be chartered in a state that, on March 5, 1987, had in effect or under consideration a law requiring ILCs to obtain deposit insurance.[41] ILCs currently operate in seven states—California, Colorado, Hawaii, Indiana, Minnesota, Nevada and Utah—that authorize the chartering of FDIC-insured ILCs.[42] Second, the ILC must either have assets of less than $100 million or must refrain from accepting demand deposits (i.e., checking accounts payable on demand).[43]

ILCs with assets of more than $100 million may not offer demand deposits, but they can offer negotiable order of withdrawal (NOW) accounts to individuals and nonprofit organizations.[44] NOW accounts are functionally equivalent to interest-bearing checking accounts.[45] Accordingly, ILCs of all sizes can offer deposit accounts with check-writing features to all of their customers except for-profit businesses.[46] ILCs chartered under Utah law may use the title "bank" in their names and may exercise powers comparable to those of a state-chartered commercial bank, including the acceptance of deposits (except for demand deposits) and the making of consumer and commercial loans.[47]

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[37] *See id.* at 49,458; *see also* FDIC Moratorium Notice, *supra* note 13, at 5292–93.

[38] 12 U.S.C. §§ 1841–50 (2000).

[39] *See* U.S. GEN. ACCOUNTABILITY OFFICE, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 15, 65–67 (2005), *available at* http://www.gao.gov/cgi-bin/getrpt?GAO-05-621 [hereinafter GAO-ILC Report]; *infra* Part III.B.3 (discussing BHC Act).

[40] 12 U.S.C. § 1841(c)(2)(H) (2000); *see infra* notes 180–81 and accompanying text (discussing exemption for ILCs).

[41] 12 U.S.C. § 1841(c)(2)(H)(i).

[42] *See* FDIC Moratorium Notice, *supra* note 13, at 5291; *On Industrial Loan Companies: A Review of Charter, Ownership and Supervision Issues, Before the H. Comm. on Fin. Servs.* 2 (July 12, 2006) (statement of Douglas H. Jones, Acting General Counsel of the FDIC) (on file with Connecticut Law Review), *available at* http://www.fdic.gov/news/news/speeches/archives/2006/chairman/spjul1107.html [hereinafter Statement of Douglas H. Jones].

[43] 12 U.S.C. § 1841(c)(2)(H)(i). An ILC is also exempt from treatment as a "bank" under the BHC Act if it has not undergone a change of control since August 10, 1987, or if it does not engage, either directly, indirectly or through an affiliate, in any activity in which it was not engaged as of March 5, 1987. *Id.* According to the FDIC, only twelve ILCs that are currently in operation were insured by the FDIC prior to August 10, 1987. Thus, only a small number of ILCs could potentially rely on these grandfathered authorities. *See* Statement of Douglas H. Jones, *supra* note 42.

[44] 12 U.S.C. § 1832 (2000); *see* GAO-ILC REPORT, *supra* note 39, at 23–24.

[45] *See* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1156–57, n. 99 (1990).

[46] *See* GAO-ILC REPORT, *supra* note 39, at 6 n.5.

[47] *See* Utah Code Ann. § 7-1-701(3)(a)(iv) (2006) (authorizing industrial banks to use the word "bank" in their names); Industrial Bank Subsidiaries of Financial Companies: Notice of Proposed Rulemaking, 72 Fed. Reg. 5217, 5221 n.32 (Feb. 5, 2007) [hereinafter FDIC Proposed Rule on Consolidated Supervision] (stating that "Utah industrial banks have essentially the same powers as

In addition, the Federal Deposit Insurance Act (FDI Act)[48] grants to ILCs the same powers and privileges that it provides to other FDIC-insured state banks.[49] For example, an ILC may "export" the interest rates permitted by the state in which it is "located" when the ILC makes loans to borrowers residing in other states.[50] An ILC may also establish interstate branches based on the same terms that apply to other FDIC-insured state banks that are chartered by the ILC's home state.[51] Under current law, a Utah-chartered ILC—such as the proposed Wal-Mart Bank—could establish interstate de novo branches in thirty-four states.[52] In addition, a Utah ILC could operate branches throughout the nation if it was willing to acquire (and merge with) banks in the sixteen states where it could not open de novo branches.[53]

In sum, under applicable state and federal law, a commercially-owned Utah ILC can conduct a nationwide banking business as long as it refrains from accepting demand checking accounts and thereby maintains its exemption from treatment as a "bank" under the BHC Act. Currently, fifty-eight ILCs are in operation, including forty-five institutions chartered

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Utah commercial banks except that industrial banks have more limited securities powers and less specific investment authority than commercial banks"); GAO-ILC REPORT, *supra* note 39, at 21–22, 24–25.

[48] 12 U.S.C. §§ 1811–1835(a) (2000).

[49] Under the FDI Act, a state-chartered ILC that is engaged in the business of accepting deposits other than trust funds is considered to be a "State bank." 12 U.S.C. § 1813(a)(2).

[50] *See* 12 U.S.C. § 1831d; GAO-ILC REPORT, *supra* note 39, at 21–22; Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 544–69 (2004) (discussing the legal doctrine permitting FDIC-insured banks to "export" interest rates).

[51] *See* 12 U.S.C. §§ 1828(d)(4), 1831u; GAO-ILC Report, *supra* note 39, at 78–79; PATRICIA A. MCCOY, BANKING LAW MANUAL § 9.04 (2d ed. 2006) (discussing statutes authorizing interstate expansion by FDIC-insured banks).

[52] Currently, FDIC-insured banks may establish interstate de novo branches in seventeen states that permit banks from any state to open such branches. In addition, banks headquartered in Utah can establish interstate de novo branches in seventeen additional states that have branching laws that are reciprocal with Utah's branching statute. *See* MCCOY, *supra* note 51, § 9.04[2][b](ii) (discussing restrictions on interstate de novo branching under current law); GAO-ILC REPORT, *supra* note 39, at 78–79 (discussing interstate de novo branching rights available to Utah-chartered ILCs).

In 2003 and 2004, the House considered a regulatory relief bill that would have granted nationwide de novo branching powers to all FDIC-insured banks, including ILCs. However, due to the controversy over commercially-owned ILCs, the bill passed by the House in 2004 withheld nationwide de novo branching powers from any ILC that was not in existence before October 1, 2003, or whose parent company generated more than 15% of its revenues from nonfinancial activities. *See* Christine E. Blair, *The Future of Banking in America: The Mixing of Banking and Commerce*, 16 FDIC BANKING REV. 97, 97, & n.2 (2004) (discussing House action on H.R. 1375, 108th Congress (2004)); Siobhan Hughes, *House Passes Banking Bill Despite Feud Over Regulation of Industrial Loan Companies*, CQ WEEKLY, Mar. 20, 2004, at 702, *available at* http://library.cqpress.com/cqweekly/document.php?id=weeklyreport108-000001067771&type=hitlist&num=23& (discussing the controversy surrounding the House banking bill). The provision regarding expanded de novo branching powers was omitted when Congress finally adopted regulatory relief legislation for banks in 2006. *See* Satish M. Kini & Kay E. Bondehagen, *The Financial Services Regulatory Relief Act of 2006: A Modest But Important Step Toward Regulatory Burden Reduction*, 124 BANKING L.J. 3, 5 (2007).

[53] MCCOY, *supra* note 51, § 9.04[2][b](ii).

by Utah and California with the remainder chartered by Colorado, Hawaii, Indiana, Minnesota and Nevada. Commercial firms own fifteen of those ILCs.[54]

As indicated above, California and Colorado have enacted laws barring commercial firms from acquiring ILCs chartered in those states.[55] Consequently, Utah has become the primary focus for commercial firms seeking to acquire ILCs. During 2006, the FDIC received eighteen applications to organize or acquire control of ILCs.[56] Eight applications were withdrawn after the FDIC imposed its six-month moratorium in July 2006.[57] On January 31, 2007, ten applications remained pending for action by the FDIC.[58] Commercial firms—including Wal-Mart (the world's largest retailer) and Home Depot (the second largest U.S. retailer)—filed nine of those applications.[59]

The FDIC received more than 12,600 written submissions in response to its request for comment on policy issues related to acquisitions of ILCs. Over 80% of those submissions opposed any further acquisitions of ILCs by Wal-Mart or other commercial firms.[60] In addition, more than a hundred members of Congress sent a letter to the FDIC on December 7, 2006, requesting that the FDIC extend its moratorium until Congress could act on legislation to prohibit commercial firms from acquiring or exercising control over ILCs.[61] On January 29, 2007, more than thirty members of Congress introduced such legislation in the House of Representatives.[62]

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[54] FDIC Moratorium Extension Notice, *supra* note 5, at 5291 & n.6; *see also* GAO-ILC REPORT, *supra* note 39, at 55–56 (reporting that, as of December. 31, 2004, fifty-seven ILCs were actively operating, of which Utah chartered twenty-nine, California chartered fifteen, and Nevada chartered five).

[55] *See supra* notes 24–25 and accompanying text.

[56] FDIC Moratorium Extension Notice, *supra* note 5, at 5291.

[57] *Id.*

[58] *Id.*; Price Waterhouse Coopers, *FDIC Extends Moratorium on ILC Applications*, 9 FIN. SERVS. REG. HIGHLIGHTS 1 (2007).

[59] *See* FDIC Moratorium Extension Notice, *supra* note 5, at 5291. In addition, three of the six ILCs approved by the FDIC during 2004 are owned by commercial firms (GMAC, Target and Toyota). Those recent approvals provide additional evidence of the strong interest of commercial firms in acquiring ILCs. *See* GAO-ILC Report, *supra* note 39, at 8 ("Three of the six new ILC charters approved by FDIC during 2004 are owned by nonfinancial, commercial firms"); Statement of Douglas H. Jones, *supra* note 42, at Attachment 1.

[60] FDIC Moratorium Extension Notice, *supra* note 5, at 5292. The FDIC also received more than 800 comment letters with regard to Home Depot's application to acquire EnerBank, and "almost all" of those letters opposed the acquisition. *Id.* at 5291.

[61] *Id.* at 5293; Joe Adler, *In Brief: Extension Supported for ILC Moratorium*, AM. BANKER, Dec. 8, 2006, at 3, *available at* LEXIS, News Library, AMBNKR File.

[62] *See* H.R. 698, 110th Cong. § 51(c)(1)–(3) (2007) (prohibiting any "commercial firm," defined as an entity that derives 15% or more of its annual gross revenues from non-financial activities, from exercising control over an ILC, subject to certain grandfathering provisions); Joe Adler, *In Brief: House Bill Would Limit ILC Ownership*, AM. BANKER, Jan. 30, 2007, at 5, *available at* LEXIS, News Library, File AMBNKR. By mid-February 2007, the proposed House bill had attracted forty-nine co-

On January 31, 2007, the FDIC extended its moratorium on acquisitions of ILCs by commercial firms for an additional year. At the same time, the FDIC lifted its moratorium with respect to acquisitions of ILCs by financial companies.[63] The FDIC also issued a proposed rule that would give the FDIC consolidated supervisory powers over financial companies that acquire ILCs if such companies are not already subject to consolidated supervision by the FRB or the OTS.[64]

The FDIC extended its moratorium on acquisitions of ILCs by commercial firms because it concluded that such acquisitions raise special policy issues warranting consideration by Congress. The FDIC noted that federal law does not permit commercial firms to acquire other types of FDIC-insured depository institutions.[65] The FDIC concluded that Congress should be given a "reasonable period" to decide whether to adopt new legislation governing acquisitions of ILCs by commercial firms.[66] The FDIC also stated that it had "continuing concerns about commercial ownership" of ILCs because

> the current supervisory process and infrastructure may not produce the safeguards that the FDIC believes could be helpful in identifying and avoiding or controlling, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from that kind of company-ownership model.[67]

According to the FDIC, the comments submitted on the ILC policy issues raised three major questions: (i) whether commercial ownership of ILCs produces a mixing of banking and commerce that is contrary to an established U.S. policy, (ii) whether such ownership creates undue risks for the U.S. financial system and the broader economy, and (iii) whether the FDIC has adequate supervisory powers to control such risks, despite the FDIC's lack of consolidated supervisory authority over the commercial owners of ILCs.[68] Those three questions are analyzed in the next part of this Article.

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sponsors. Joe Adler, *Gillmor on ILCs, GSEs, and What He Brings to the Table*, AM. BANKER, Feb. 13, 2007, at 1, *available at* LEXIS, News Library, File AMBNKR.

[63] FDIC Moratorium Extension Notice, *supra* note 5, at 5290. The FDIC's extended moratorium applies to acquisitions of ILCs by companies that engage in "non-financial activities" (i.e., activities other than those that are permissible for financial holding companies, bank holding companies, or savings and loan holding companies). *Id.* at 5290 & n.2.

[64] FDIC Proposed Rule on Consolidated Supervision, *supra* note 47.

[65] FDIC Moratorium Extension Notice, *supra* note 5, at 5293.

[66] *Id.*

[67] *Id.*

[68] *Id.* at 5291–93.

III. ADDRESSING THE POLICY ISSUES RAISED BY THE FDIC REGARDING OWNERSHIP OF ILCS BY COMMERCIAL FIRMS

A. *Does Commercial Ownership of ILCs Conflict with a U.S. Policy of Separating Banking and Commerce?*

Economists and legal scholars have debated whether the United States has followed a general policy of separating banking institutions from commercial enterprises.[69] As discussed below, there have been times when banks invested in, or formed affiliations with, commercial enterprises. Indeed, failures of depository institutions involved with commercial activities triggered serious financial crises on several occasions. Each crisis led to legislation that sought to establish a stricter separation between banks and commercial firms. Congress also enacted laws on several occasions in order to close perceived "loopholes" in statutes that were designed to keep banks from becoming closely intertwined with commercial businesses. Thus, the clear trend in federal banking policy has been to separate banking from commerce, a trend that has grown stronger over time. The federal statute permitting commercial ownership of ILCs appears to be the most significant remaining exception to that policy.

1. *Restrictions on Bank Activities Prior to 1900*

Scholars who believe that the United States has followed a general policy of separating banking and commerce point to federal and state laws that required banks to refrain from engaging in commercial activities during the first half-century of the nation's existence.[70] For example, in 1782 the Pennsylvania legislature granted the first bank charter in U.S. history to the Bank of North America (BONA). BONA was strongly opposed by advocates for agrarian interests, who claimed (among other things) that BONA favored the interests of Philadelphia merchants. In 1785, representatives from farming districts gained control of the Pennsylvania legislature and repealed BONA's charter.[71] The legislature restored BONA's charter in 1787, but the new charter expressly forbade the bank from trading in merchandise or from holding real estate except for use as the bank's business premises or as collateral for its loans. Thus,

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[69] *See generally* Blair, *supra* note 52 (providing an overview of the debate).

[70] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 36, 54–59 (1994); Bernard Shull, *Banking and Commerce in the United States*, 18 J. BANKING & FIN. 255, 257–59 (1994) [hereinafter Shull, *Banking and Commerce*]; Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of the Principal Issues*, 8 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS Aug. 1999, at 1, 7–9 [hereinafter Shull, *Separation Issues*]; John R. Walter, *Banking and Commerce: Tear Down This Wall?*, 89 FED. RES. BANK RICH. ECON. Q., Spring 2003, at 7, 7–8.

[71] *See* BRAY HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR 48–63 (1957).

BONA's 1787 charter expressed a clear policy of separating banking from commercial activities.[72]

Similarly, the charters for the First (1791) and Second (1816) Banks of the United States prohibited those banks from dealing in commodities or merchandise.[73] State "free banking" laws, beginning with New York's Free Banking Act of 1838, typically authorized state-chartered banks to "carry on the business of banking" by engaging in a specified list of banking functions and, in addition, to exercise "incidental powers" that were "necessary to carry on such business."[74] However, New York's banking statute and similar laws of other states did not permit banks to engage in "mercantile enterprises."[75]

Scholars who are skeptical of the strength of the policy separating banking and commerce have noted that a number of early banks did engage in commercial activities.[76] For example, in 1799 Aaron Burr persuaded the New York legislature to grant a charter to the Manhattan Company, a company organized to provide drinking water to New York City. The Manhattan Company's charter contained a provision that allowed the company to employ its surplus capital "in the purchase of public or other stock or in any other monied transactions or operations" permitted by law.[77] Burr relied on that provision to create the Bank of the Manhattan Company (the predecessor of Chase Manhattan Bank, which eventually became part of J.P. Morgan Chase & Co.).[78] However, Burr's political opponents alleged that he had used an ambiguous charter provision to trick the New York legislature into giving unintended banking powers to the Manhattan Company. The resulting political controversy undercut Burr's attempt to secure the Presidency when the election of 1800 was thrown into the House of Representatives.[79]

Despite the controversy created by the Bank of the Manhattan Company, it was not the only bank to engage in commercial activities during the first half of the 19th century. The most notable early bank with commercial interests was the Bank of the United States of Philadelphia (BUSP). BUSP was organized in 1836 to carry on the nongovernmental

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[72] *Id.* at 63.

[73] *See* HERMAN E. KROOSS & MARTIN R. BLYN, A HISTORY OF FINANCIAL INTERMEDIARIES 21, 44 (1971).

[74] Edward L. Symons, Jr., *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676, 690 (1983) (quoting ch. 260, § 18, 1838 N.Y. Laws 245, 249).

[75] Shull, *Separation Issues*, *supra* note 70, at 9; Symons, *supra* note 74, at 697–98.

[76] *See, e.g.*, Joseph G. Haubrich & Joao A.C. Santos, *Alternative Forms of Mixing Banking and Commerce: Evidence from American History*, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS, May 2003, at 121.

[77] HAMMOND, *supra* note 71, at 152 (quoting the New York statute granting a charter to the Manhattan Company).

[78] *Id.* at 149–54, 156; Haubrich & Santos, *supra* note 76, at 121–22; Symons, *supra* note 74, at 687–88.

[79] HAMMOND, *supra* note 71, at 152–57.

business of the Second Bank of the United States after President Andrew Jackson vetoed congressional legislation that would have renewed the Second Bank's federal charter.[80] Nicholas Biddle, the Second Bank's president, obtained a charter for BUSP from the Pennsylvania legislature. BUSP's state charter required the bank to underwrite bonds issued by the Pennsylvania state government and to invest in various enterprises sponsored by the state government for the purpose of building public improvement projects. The charter also gave BUSP a broad power to purchase government securities and bank stocks.[81]

Under Biddle's leadership, BUSP used its investment banking powers to become "what amounted to a universal bank."[82] By 1840, BUSP owned stock in more than twenty banks, including a controlling interest in the Morris Canal and Banking Company of New Jersey (Morris Bank) and shares in several southern banks. BUSP also held stock in companies engaged in a wide array of public works projects (including bridges, canals, railroads and turnpikes) and manufacturing enterprises.[83]

Together with Morris Bank, BUSP became the primary marketing agent for the sale of state government bonds to investors in New York, Philadelphia and London. Both banks helped state governments to issue bonds to provide financing for state-sponsored banks and public improvement projects during the late 1830s.[84] BUSP also became the largest financing agency for the production and international sale of cotton (a commodity that was America's largest export and Great Britain's most significant import during the 1830s). Biddle and his fellow officers took out large loans from BUSP, purchased massive amounts of cotton, and effectively controlled the sale of American cotton to Britain during 1837–1839.[85]

By 1841, BUSP held over $30 million of state bonds and corporate stocks, representing more than a third of its assets. BUSP also incurred heavy liabilities from its trading activities in foreign exchange and its

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[80] *See id.* at 405–12, 439–40 .

[81] *See id.* at 439–42; 2 FRITZ REDLICH, THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS 339 (Johnson Reprint Corp. 1968) (1951); Namsuk Kim & John Joseph Wallis, *The Market for American State Government Bonds in Britain and the United States, 1830–43*, 58 ECON. HIST. REV. 736, 753 (2005); Symons, *supra* note 74, at 688–89.

[82] John Joseph Wallis, *What Caused the Crisis of 1839?* 20 (Nat'l Bureau of Econ. Res., Working Paper No. 133, 2001).

[83] *See* HAMMOND, *supra* note 71, at 441; REDLICH, *supra* note 81, at 340–41; Wallis, *supra* note 82, at 20.

[84] *See* VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 2–3 (1970); HAMMOND, *supra* note 71, at 441; REDLICH, *supra* note 81, at 340–42; Kim & Wallis, *supra* note 81, at 742–45, 753–55; Wallis, *supra* note 82, at 18–21, 23, 25–27, 33; *see also* John Joseph Wallis, Richard E. Sylla & Arthur Grinath III, *Sovereign Debt and Repudiation: The Emerging-Market Debt Crisis in the U.S. States, 1839–1843*, at 1, 5–12, 34 tbl.3 (Nat'l Bureau Econ. Research, Working Paper No. 10753, 2004) (showing that states issued more than $100 million of bonds in 1837–1841 in response to a boom in land values, primarily for the purpose of sponsoring banks and public improvements).

[85] HAMMOND, *supra* note 71, at 467–74; Wallis, *supra* note 82, at 22–25.

financing arrangements for the production and export of cotton. Due to its speculative activities in securities, foreign exchange and commodities, most of BUSP's assets proved to be illiquid and non-marketable when cotton prices fell and the domestic economy slumped in 1839. BUSP suffered devastating losses, suspended specie payments on its circulating notes in 1839, and closed its doors in 1841. For similar reasons, BUSP's affiliate, the Morris Bank, became insolvent in 1839 and failed in 1841.[86]

The collapse of BUSP and Morris Bank caused severe problems in several states. Both banks failed to make payments on bonds that they had purchased as underwriters for the Indiana and Michigan state governments but had not been able to resell. As a result of BUSP's and Morris Bank's failures, both Indiana and Michigan defaulted on their bond obligations in 1841. BUSP's failure also deprived Pennsylvania of a vital source of credit, without which the state could not pay its outstanding bonds. Pennsylvania therefore defaulted on its bonds in 1842.[87] In addition, because BUSP played a crucial role in financing the cotton trade, the bank's collapse caused a sharp decline in cotton exports to Britain and contributed to a severe recession in the south.[88]

Economic dislocations in both the midwest and south produced a steep drop in land values and undermined many state-sponsored projects to build and operate canals, highways and railroads. Several midwestern and southern states had sponsored banks to promote land development schemes and to finance public improvements. The state governments issued bonds to capitalize the banks, and the banks were obligated to repay the bonds out of the income they earned from their land mortgages and their investments in public improvement projects. Due to widespread defaults on land mortgages and the collapse of public improvement ventures, many state-sponsored banks failed when they could not meet their bond obligations. Failures of state-sponsored banks caused Arkansas, Florida, Illinois, Louisiana and Mississippi to default on their outstanding bonds.[89] Alabama incurred heavy costs in dealing with the collapse of its state-sponsored banks, but the state imposed new taxes and succeeded in paying off the bonds it had issued to the banks.[90]

The collapse of BUSP, Morris Bank and numerous state-sponsored banks, and the associated bond defaults by state governments, produced

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[86] CAROSSO, *supra* note 84, at 2–3; HAMMOND, *supra* note 71, at 441, 500–12, 535–40; REDLICH, *supra* note 81, at 341–43; Wallis, *supra* note 82, at 22–28, 42 tbl.6.

[87] Kim & Wallis, *supra* note 81, at 743–45, 753–56, 758–59; Wallis, Sylla & Grinath, *supra* note 84, at 17–20, 22–24.

[88] *See* Wallis, *supra* note 82, at 10–12.

[89] Wallis, Sylla & Grinath, *supra* note 84, at 5–16, 20; *see also* HAMMOND, *supra* note 71, at 612, 680–81, 686 (discussing failures of state-sponsored banks in Indiana, Illinois, Missouri and New Orleans); Wallis, *supra* note 82, at 15–20, 28–34 (discussing relationship between the collapse of the land boom and the failures of state-sponsored banks that invested in land development projects).

[90] Wallis, Sylla & Grinath, *supra* note 84, at 16.

widespread public outrage against the banks. Critics argued that banks should never have been allowed to engage in speculative securities activities or to make long-term investments in business firms, land development programs, and public improvement projects. Accordingly, banking statutes adopted by New York and other states after 1837 did not permit banks to engage or invest in such enterprises. Instead, those state laws generally required banks to limit their activities to issuing circulating bank notes, accepting deposits, providing short-term credit based on negotiable instruments, and making longer-term loans that were secured by land mortgages, high-grade government bonds or other qualifying assets.[91]

When Congress decided to establish a new system of national banks in 1863, Congress used New York's Free Banking Act of 1838 as its model for defining the powers of national banks.[92] As amended in 1864, the National Bank Act authorized national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking," including five specified functions—discounting negotiable instruments; receiving deposits; buying and selling exchange, coin and bullion; lending money on personal security; and issuing circulating notes.[93] The narrow scope of powers granted by the National Bank Act was confirmed in four decisions issued by the Supreme Court between 1870 and 1910. Those decisions held that national banks were prohibited from acquiring ownership interests in commercial enterprises, except for the limited purposes of compromising bona fide creditor claims and obtaining security for debts previously contracted.[94]

As a consequence of the limitations on bank powers contained in the National Bank Act and state banking laws, very few commercial banks engaged in investment banking activities between 1841 and the end of the 19th century. Until 1900, investment banking was primarily the domain of private banks, which were organized as partnerships in order to avoid being regulated under the statutes governing commercial banks.[95]

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[91] *See* CAROSSO, *supra* note 84, at 3; HAMMOND, *supra* note 71, at 674–84, 698–704; KROOSS & BLYN, *supra* note 73, at 78–81; ROBERT E. LITAN, WHAT SHOULD BANKS DO? 17 (1987); Symons, *supra* note 74, at 689–90, 697–98.

[92] *See* HAMMOND, *supra* note 71, at 724–25, 727–28; Symons, *supra* note 74, at 689, 698–700.

[93] Symons, *supra* note 74, at 700 (quoting Act of June 3, 1864 § 8, 13 Stat. 99, 101).

[94] *See* Symons, *supra* note 74, at 703–04, 707–09 (discussing Merchants Nat'l Bank of Cincinnati v. Wehrmann, 202 U.S. 295 (1906); First Nat'l Bank of Ottawa v. Converse, 200 U.S. 425 (1906); California Bank v. Kennedy, 167 U.S. 362 (1897); and First Nat'l Bank of Charlotte v. Nat'l Exchange Bank of Baltimore, 92 U.S. 122 (1875)).

[95] *See, e.g.*, CAROSSO, *supra* note 84, at 5–97; HAMMOND, *supra* note 71, at 703–04; *see also* Haubrich & Santos, *supra* note 76, at 127–30 (acknowledging that most of the banks involved in commercial activities during the second half of the 19th century were private investment banks). The First National Bank of New York was the most prominent commercial bank (and one of relatively few such banks) that provided investment banking services to business enterprises during the late 19th century. REDLICH, *supra* note 81, at 389–90.

2. *Limitations on Bank Powers and Affiliations, 1900–1933*

In 1900, most banking scholars adhered to the real bills doctrine, which held that commercial banks should engage primarily in accepting deposits and making short-term loans to finance the production and sale of goods. Adherents of the real bills doctrine believed that banks should not invest in illiquid assets like corporate securities and real estate nor should they make long-term loans secured by such collateral.[96] The "real bills doctrine" was broadly consistent with the limitations on bank powers imposed by the National Bank Act of 1864 and most of the state banking laws adopted after 1837.[97]

However, during the first two decades of the 20th century, and to a much greater extent after the First World War, national banks and state banks expanded their operations far beyond the traditional boundaries marked by the National Bank Act of 1864 and 19th century state banking statutes. Commercial banks established bond departments and securities affiliates that traded in securities, underwrote securities, and made long-term investments in commercial enterprises. Banks also established affiliates that pursued other types of commercial ventures, including the development of commercial real estate.[98]

a. The Great Depression and the Banking Crises of 1930–1933

During the 1920s, large urban financial institutions grew rapidly and established extensive networks of nonbank affiliates.[99] Unfortunately, several of those financial conglomerates did not survive the economic downturn that followed the Crash of 1929. The collapse of those organizations helped to trigger a series of banking panics during the Great

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[96] *See* W. NELSON PEACH, THE SECURITY AFFILIATES OF NATIONAL BANKS 9–12, 169, 177 (1941); Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921–33? A Preliminary Assessment*, *in* 4 INT'L MONETARY FUND, CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 559, 564–66 (2005), *available at* http://ssrn.com/abstract=838267; *see also* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 485, 501–03 (1971) (describing the "real bills" doctrine as strongly affecting monetary policy during this period).

[97] PEACH, *supra* note 96, at 9, 169; *see also* HAMMOND, *supra* note 71, at 698–704 (describing the primary activities of banks circa 1857); Shull, *Separation Issues*, *supra* note 70, at 9–10.

[98] *See* CAROSSO, *supra* note 84, at 96–100, 271–79; PEACH, *supra* note 96, at 16–21, 28–42, 53–112; Wilmarth, *supra* note 96, at 569–73, 579; *see also Operation of the National and Federal Reserve Banking Systems: Hearings on S. 4115 before the Sen. Comm. on Banking and Currency*, 72d Cong., 391–92 (1932) (testimony of Governor Eugene Meyer of the Federal Reserve Board) (providing a list of 770 nonbanking subsidiaries and affiliates of national banks, including 192 securities companies and 155 realty companies).

[99] *See, e.g.*, RAYMOND W. GOLDSMITH, THE CHANGING STRUCTURE OF AMERICAN BANKING 108–10, 131–58 (1933); W. RALPH LAMB, GROUP BANKING: A FORM OF BANKING CONCENTRATION AND CONTROL IN THE UNITED STATES 55–58, 80–90 (1962) (explaining the development of various types of multi-office banking organizations); PEACH, *supra* note 96, at 53–112 (describing the development and activities of security affiliates).

Depression. Congress responded to those disasters by adopting legislation in 1933 that imposed a series of new restrictions on bank powers and bank affiliations.[100]

For example, Caldwell and Company (CAC) and Bank of United States (BUS) expanded aggressively during the 1920s and established large conglomerate organizations. CAC, an investment banking firm headquartered in Nashville, Tennessee, created a financial and commercial empire that covered much of the southeast.[101] By 1929, CAC was the leading underwriter of municipal bonds, industrial revenue bonds and real estate bonds in the southern states.[102] CAC underwrote securities issued by more than twenty southern companies and acquired controlling interests in most of those firms.[103] CAC also purchased numerous banks and insurance companies.[104] By 1930, CAC controlled a large chain of banks with $213 million of assets, several insurance companies with $230 million of assets, and commercial firms and newspapers with $50 million of assets.[105] CAC became the "dominant investment banker of the South" and was called the "Morgan of the South."[106] CAC formed a political alliance with Governor Henry Horton of Tennessee during the late 1920s, an alliance that produced significant financial benefits for CAC.[107]

CAC's financial structure was heavily leveraged, because it financed most of its acquisitions with debt. In order to obtain funding for its operations CAC sold large amounts of low-quality securities to its principal affiliated bank, the Bank of Tennessee (BOT). BOT paid for those securities by using funds deposited in BOT by state and municipal governments and companies controlled by CAC. In addition, CAC took out large loans from its other affiliated banks. CAC's affiliated banks greatly increased their transfers of funds as CAC's financial position deteriorated in 1929–1930.[108] The economic downturn that followed the

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[100] *See infra* Part III.A.2.b.

[101] *See generally* JOHN BERRY MCFERRIN, CALDWELL AND COMPANY: A SOUTHERN FINANCIAL EMPIRE 8–47 (Vanderbilt University Press 1969) (1939) (providing background on Caldwell and Company's early development and expansion).

[102] *See id.* at 11, 21, 23, 29, 47.

[103] *Id.* at 37, 39–40.

[104] *See id.* at 24–28.

[105] *Id.* at 79–80, 117.

[106] *Id.* at 117, 119.

[107] *See id.* at 103–15, 162, 248–49. In 1928, CAC provided extensive financial support that enabled Horton to win a narrow victory in the Democratic primary and a comfortable victory in the general election. *Id.* at 104–07. In return, Governor Horton provided many favors to CAC. For example, Horton instructed the Tennessee state highway commissioner to issue large contracts on a no-bid basis to an asphalt company controlled by CAC, and he caused the Tennessee state government to deposit more than $8 million in CAC's affiliated banks. *Id.* at 103–04, 113. More than $6 million of state funds were still on deposit when the banks closed in November 1930. *Id.* at 162.

[108] *See id.* at 62–63, 67, 119–25, 150–62, 235. For example, before CAC collapsed it sold $12.6 million of securities to BOT. CAC had acquired those securities in connection with underwriting commitments but could not resell them to the public. CAC agreed to repurchase the securities on

Crash of 1929 proved fatal for CAC. By 1930, CAC held very little cash or marketable securities, and most of its assets consisted of illiquid investments in the stock of its affiliates and other securities that CAC had agreed to underwrite but could not sell to the public.[109] As rumors of CAC's problems spread, depositors and other creditors made heavy withdrawals from CAC and its affiliated banks.[110]

The collapse of CAC in November 1930 precipitated a regional banking panic that resulted in the failure of all but two of CAC's affiliated banks and many of their correspondent banks. Scholars have linked CAC's demise to the failure of more than 120 banks in Arkansas, Kentucky, North Carolina and Tennessee.[111] In addition, most of the insurance companies, commercial firms and newspapers controlled by CAC were forced into receivership, and most of the corporate and real estate bonds underwritten by CAC went into default. The contagious effects of CAC's collapse inflicted a severe shock on the southern economy.[112]

BUS was a New York state-chartered bank that expanded rapidly during the 1920s by acquiring several other banks. By May 1929, BUS operated nearly sixty branches in Manhattan, Brooklyn, the Bronx and Queens and held more than $300 million in assets. BUS was a member of the Federal Reserve System (FRS) and ranked among the thirty largest banks in the United States. BUS also controlled three securities affiliates, an insurance company and more than twenty real estate affiliates.[113] BUS established its securities and real estate affiliates for the specific purpose of evading restrictions imposed by New York's banking laws on securities underwriting and long-term real estate investments.[114]

BUS made large loans to real estate developers, both directly and indirectly through its real estate affiliates. BUS also invested in real estate bonds that were issued to finance apartment buildings and other commercial real estate projects. By August 1929, BUS held more than $70

BOT's demand, but CAC defaulted on that obligation. Thus, CAC effectively used BOT as a "dumping ground for nonsalable Caldwell securities." *Id.* at 232, 235.

[109] *See id.* at 119–23, 141–42, 231. In addition, during 1927–1929, CAC made aggressive but ill-timed short sales of popular stocks on Wall Street with the expectation that the stock market boom was about to end. CAC's short sales produced losses that wiped out one-fifth of its net worth by mid-1929. CAC stopped its short-selling campaign in June 1929, a few months before it could have produced significant profits. *Id.* at 122.

[110] *Id.* at 178–80.

[111] CAROSSO, *supra* note 84, at 308–09; GOLDSMITH, *supra* note 99, at 225–26; MCFERRIN, *supra* note 101, at 176–88, 230–40; Wilmarth, *supra* note 96, at 594; Gary Richardson, *Bank Distress During the Great Contraction, 1929 to 1933, New Data from the Archives of the Board of Governors* 7–8, 18–21, 25–27 (Nat'l Bureau of Econ. Research, Working Paper No. 12590, 2006), *available at* http://www.nber.org/papers/w12590.

[112] *See* MCFERRIN, *supra* note 101, at 238–45.

[113] M.R. WERNER, LITTLE NAPOLEONS AND DUMMY DIRECTORS: BEING THE NARRATIVE OF THE BANK OF UNITED STATES 6–7, 13–63, 125–26 (1933); Wilmarth, *supra* note 96, at 594–95.

[114] *See* WERNER, *supra* note 113, at 24–28, 125–26.

million in loans and investments related to real estate, and most of those assets were classified by New York state bank examiners as "frozen."[115]

BUS also made substantial loans to its officers and its securities affiliates in order to finance trading operations in its stock units, each of which consisted of one BUS share combined with one share of its principal securities affiliate. By 1930, BUS had committed $16 million (equal to one-third of its capital) to support the market price of its stock units. BUS had a strong incentive to maintain a high market price for its stock units, because it had agreed to repurchase those units at guaranteed minimum prices from many of its shareholders, including depositors to whom BUS had actively marketed its units.[116]

BUS was doomed when the stock market and real estate values slumped after the Crash of 1929. By the time BUS failed in December 1930, its securities and real estate affiliates owed more than $20 million to the bank. BUS also held $11 million of loans secured by its stock units and $8 million of real estate bonds. "Large amounts of BUS's real estate loans were either in default or likely to default."[117] BUS collapsed after the New York state banking commissioner and the Federal Reserve Bank of New York failed to persuade members of the New York Clearing House Association (NYCHA) to provide financial support for an emergency merger between BUS and two other New York City banks.[118] In response to BUS's failure, depositor runs occurred at three New York City banks that were associated with BUS. The smallest of the three banks failed, but members of the NYCHA intervened to save the larger two banks, thereby averting a more widespread banking panic.[119]

Most scholars have concluded that the failures of CAC and BUS represented serious blows to the U.S. banking system and set the stage for subsequent and more serious banking crises during 1931–1933. CAC's demise triggered a regional banking panic, and BUS's collapse represented the largest bank failure up to that time. Because of BUS's name, its size and its status as an FRS member bank, BUS's failure received wide coverage in domestic and international newspapers. BUS's collapse also created growing doubts about the Federal Reserve's ability to prevent

[115] *See id*. at 21–23, 125–30, 135; Paul B. Trescott, Rejoinder, *The Failure of the Bank of United States, 1930*, 24 J. MONEY, CREDIT & BANKING 384, 391, 394 (1992).

[116] *See* WERNER, *supra* note 113, at 55, 59–60, 97–109, 112–17; Trescott, *supra* note 115, at 390–91, 393.

[117] Trescott, *supra* note 115, at 393–94; Wilmarth, *supra* note 96, at 595.

[118] *See* MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867–1960, at 309–10 n.9 (1963); HAROLD VAN B. CLEVELAND & THOMAS F. HUERTAS, CITIBANK 1812–1970, at 166, 395–97 nn.28–35 (1985); BARRIE A. WIGMORE, THE CRASH AND ITS AFTERMATH: A HISTORY OF SECURITIES MARKETS IN THE UNITED STATES, 1929–1933, at 123–25 (1985).

[119] *See* FRIEDMAN & SCHWARTZ, *supra* note 118, at 310 n.9; GOLDSMITH, *supra* note 99, at 227; WIGMORE, *supra* note 118, at 125, 128, 250.

major bank failures. In combination, the failures of CAC and BUS produced a substantial outflow of currency from the banking system as depositors converted their deposits into cash. That outflow indicated a significant loss of public confidence in the banking system.[120]

Financial conglomerates continued to encounter significant problems during the remainder of the Great Depression. Bank of America, the third largest U.S. bank, and its parent holding company, Transamerica Corporation, suffered crippling losses due to speculative investments in stocks, defaults on loans made to investors in securities, and nonperforming real estate loans. In order to survive, Bank of America sold its New York banking and securities affiliates in 1931 and obtained a $65 million loan from the Reconstruction Finance Corporation (RFC) in 1932.[121] Similarly, the RFC extended a $90 million loan in 1932 to finance an emergency reorganization of Central Republic Bank, the third largest bank in Chicago. The RFC acted after depositor runs took place at numerous banks in Chicago and it became clear that a banking panic with regional and potentially nationwide effects would occur if the RFC failed to protect Central Republic's depositors.[122]

However, the RFC was unable to prevent the collapse of the two largest bank holding companies in Detroit—Guardian Detroit Union Group and Detroit Bankers Company—in early 1933. Both holding companies expanded rapidly during the 1920s, established securities affiliates, and held extensive investments in securities and real estate. By early 1933, heavy losses from their securities and real estate operations left both banking groups insolvent, and the RFC could not marshal sufficient resources to prevent their failure. The collapse of the leading Detroit banking organizations precipitated a nationwide banking panic that

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[120] *See* FRIEDMAN & SCHWARTZ, *supra* note 118, at 308–12; VAN B. CLEVELAND & HUERTAS, *supra* note 118, at 166–67, 395 n.28, 397 nn.34–35; Richardson, *supra* note 111, at 7–8, 21–22, 25–28. Elmus Wicker agrees that CAC's collapse had a significant negative impact on the banking system, but he questions the importance of the BUS failure. *See* ELMUS WICKER, THE BANKING PANICS OF THE GREAT DEPRESSION 29–38, 52–59 (1996).

[121] GOLDSMITH, *supra* note 99, at 198–200; Wilmarth, *supra* note 96, at 599; *see also* VAN B. CLEVELAND & HUERTAS, *supra* note 118, at 169, 399 n.46 (describing Bank of America as the third largest bank and Transamerica as its holding company).

[122] JESSE H. JONES, FIFTY BILLION DOLLARS: MY THIRTEEN YEARS WITH THE RFC 72–79 (1951); WICKER, *supra* note 120, at 112–14; Wilmarth, *supra* note 96, at 597–98 (noting that Central Republic had suffered devastating losses from its real estate operations and its financial support for the Insull utility empire). Subsequently, in 1933 and 1934, the RFC purchased $150 million of preferred stock from National City Bank, Chase National Bank, and Continental Illinois Bank to help them recover from severe losses, including heavy losses incurred by their securities operations. *See* VAN B. CLEVELAND & HUERTAS, *supra* note 118, at 159–61, 191, 211 tbl.10-5, 391 n.4 (discussing National City Bank); JONES, *supra*, at 35–36, 47–49 (describing purchases from all three banks); WIGMORE, *supra* note 118, at 468–70 (same); Wilmarth, *supra* note 96, at 602–03 (same).

culminated in the national bank holiday declared by President Franklin Roosevelt on March 6, 1933.[123]

b. The Banking Act of 1933

Congress responded to the banking crises of 1930–1933 by adopting the Banking Act of 1933 (1933 Act), popularly known as the "Glass-Steagall Act."[124] During the hearings and debates that led to the passage of the 1933 Act, members of Congress frequently referred to the disastrous consequences of the downfall of CAC, BUS, and the two largest Detroit banks.[125] Congress identified speculative operations involving securities and real estate—factors that had doomed all four banks—as important contributing causes to the generalized collapse of the banking system and the national economy. Congress also criticized banks for using affiliates to circumvent existing statutory restraints on investment banking activities and real estate investments.[126]

Several provisions of the 1933 Act imposed restrictions on bank ownership of interests in commercial enterprises. Sections 5(c) and 16, which still remain in effect, prohibit national banks and state banks that are members of the Federal Reserve System from underwriting, dealing or investing in equity securities or in debt securities (except for investment-grade, "bank-eligible" debt securities issued by qualifying issuers).[127] Section 21, which also remains in effect, prohibits state nonmember banks and all other persons engaged in the business of accepting deposits from underwriting, selling or distributing any type of securities (except for bank-eligible securities).[128] In addition, as discussed below, a 1991 statute extended section 16's prohibition on equity investments to reach FDIC-insured state nonmember banks. That statute generally prevents insured state nonmember banks from holding equity investments that are not permissible for national banks.[129]

[123] GOLDSMITH, *supra* note 99, at 168–69, 204–05, 235–36; JONES, *supra* note 122, at 17–20, 54–69; WICKER, *supra* note 120, at 117–29; WIGMORE, *supra* note 118, at 51, 120–21, 324–25, 434–46; Wilmarth, *supra* note 96, at 600–02.

[124] Wilmarth, *supra* note 96, at 560, 564–65.

[125] *Id.* at 568.

[126] *Id.* at 564–69, 576–69, 611–12; *see also, e.g.*, S. REP. NO. 73-77, at 3–10 (1933); 77 CONG. REC. 3725–26 (1933) (remarks of Sen. Glass); *id.* at 3835–36 (remarks of Rep. Steagall); 75 CONG. REC. 9887–89 (1932) (remarks of Sen. Glass); *id.* at 9904–05 (remarks of Sen. Walcott); *id*. at 9909–13 (remarks of Sen. Bulkley).

[127] 1933 Act §§ 5(c), 16, 12 U.S.C. §§ 335, 24 (2000); *see* MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 4.03[A] (3d ed. 2007) (discussing section 16 of the 1933 Act); MCCOY, *supra* note 51, § 7.02[1] (discussing sections 5(c) and 16 of the 1933 Act). State banks that are members of the Federal Reserve System are hereinafter referred to as "state member banks" and other state banks (including ILCs) are called "state nonmember banks."

[128] 1933 Act § 21(a)(1), 12 U.S.C. § 378(a)(1) (2000); *see* FEIN, *supra* note 127, § 4.03[B] (discussing section 21 of the 1933 Act); MCCOY, *supra* note 51, § 7.02[1] (same).

[129] *See* 12 U.S.C. § 1831a(c), (f); FEIN, *supra* note 127, § 4.03[B] (discussing § 1831a); *see infra* notes 239–41 and accompanying text (discussing 1991 statute).

Sections 20 and 32 of the 1933 Act prohibited national banks and state member banks from affiliating with securities underwriters and dealers. As explained below, Congress repealed those provisions in 1999.[130] However, Congress adopted four additional restrictions on bank affiliates in 1933, and those restrictions remain in effect. First, Congress imposed limits on financial transactions between FRS member banks and their affiliates by adopting a new section 23A of the Federal Reserve Act.[131] Second, Congress placed limitations on the authority of national banks and state member banks to provide equity capital or loans to corporations holding real estate used as bank premises.[132] Third, Congress required state member banks and national banks to separate their stock certificates from the stock certificates of their nonbank affiliates.[133] Fourth, Congress authorized bank regulators to examine affiliates to evaluate their effect on the affairs of their affiliated banks.[134] Thus, the 1933 Act reflected Congress's determination to "separate as far as possible national banks and [state] member banks from affiliates of all kinds," and to "install a satisfactory examination of affiliates, working simultaneously with the present system of examination applicable to the parent banks."[135]

Congress also responded in 1933 to the rapid growth of bank holding companies and the problems that many of those companies encountered during the Great Depression. Since 1900, bank owners had organized holding companies in order to create networks of jointly-owned banks while avoiding restrictions on branching under federal and state law.[136] Bank holding companies expanded rapidly during the economic boom of the 1920s.[137] However, during the Great Depression, 200 banks that were

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[130] Sections 20 and 32 of the Glass-Steagall Act, repealed in 1999, prohibited national banks and state member banks from affiliating with, or having interlocking directors or officers with, any firm that was "engaged principally" in the issuance, underwriting, public sale or distribution of bank-ineligible securities. 1933 Act §§ 20, 32, 48 Stat. 188, 194; *see also* FEIN, *supra* note 127, § 4.03 [C], [D] (discussing sections 20 and 32 of the 1933 Act); *infra* notes 244–46 and accompanying text (discussing 1999 statute).

[131] 1933 Act § 13, 12 U.S.C. § 371c (2000). Section 23A limits the total amount of "covered transactions" between a bank and any one affiliate to 10% of the bank's capital and surplus. The statute also limits the total amount "covered transactions" between a bank and all of its affiliates to 20% of the bank's capital and surplus. "Covered transactions" include extensions of credit by the bank or purchases of securities or assets by the bank. In addition, section 23A requires all extensions of credit by a bank to an affiliate to be secured by qualifying collateral. *Id.* As enacted in 1933, section 23A applied only to FRS member banks, but Congress subsequently extended the statute to reach state nonmember banks. 12 U.S.C. § 1828(j) (2000); *see also* FEIN, *supra* note 127, § 2.02[B][2] (discussing section 23A of the 1933 Act).

[132] 1933 Act § 14, 12 U.S.C. § 371d (2000).

[133] 1933 Act §§ 5(c), 18, 12 U.S.C. §§ 336, 52 (2000).

[134] 1933 Act §§ 5(c), 28, 12 U.S.C. §§ 338, 481 (2000). In 1966, Congress gave the FDIC parallel authority to examine affiliates of FDIC-insured state nonmember banks. Act of Oct. 16, 1966, Pub. L. No. 89-695, § 203, 80 Stat. 1028, 1053 (codified as amended at 12 U.S.C. § 1820 (2000)).

[135] S. REP. NO. 73-77, at 10 (1933).

[136] LAMB, *supra* note 99, at 8–11, 28–35, 80–82, 86–87.

[137] *Id.* at 82–90.

subsidiaries of holding companies failed. The most devastating failures resulted from the collapse of CAC and the two Detroit holding companies.[138] Twenty-four bank holding companies became insolvent and dissolved during 1931–1936, resulting in a significant reduction in the number of bank holding companies and the amount of their assets.[139]

In response to concerns about the lack of federal rules governing bank holding companies, Congress included two provisions in the Banking Act of 1933. Those provisions required bank holding companies to register with the FRB, to submit to examinations by the FRB, to maintain required reserves, and to obtain voting permits if such companies wished to vote the stock of state member banks or national banks.[140] However, most bank holding companies avoided these provisions by refraining from voting the stock of their subsidiary banks.[141]

3. *Restrictions on Bank Affiliations, 1956–1987*

a. The Bank Holding Company Act of 1956

Bank holding companies expanded again after the Second World War.[142] Transamerica was the most aggressive of these companies and acquired numerous banks and commercial enterprises. By 1956, Transamerica controlled banks in ten states as well as several insurance companies and commercial businesses engaged in oil and gas development, fish canning and processing, frozen foods, and a variety of manufacturing ventures.[143] Several other bank holding companies also controlled commercial firms involved in oil and gas development, real estate development, home construction and manufacturing.[144]

Congress adopted the Bank Holding Company Act (BHC Act) in 1956[145] in order to control the growth of bank holding companies and to

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[138] *Id.* at 92–94.

[139] *Id.* at 97–99. Between 1931 and 1936, total loans and investments held by bank holding companies fell from $8.7 billion to $5.5 billion. *Id.* at 98.

[140] 1933 Act, §§ 5(c), 19, 48 Stat. 162, 166, 186–87. Congress repealed these provisions in 1966. Act of July 1, 1966, Pub. L. No. 89-485, § 13(c), (g), 80 Stat. 236, 242–243; *see also* S. REP. NO. 89-1179 (1966), *as reprinted in* 1966 U.S.C.C.A.N. 2385, 2396 (discussing repeal of voting permit requirement).

[141] H.R. REP. NO. 84-609, at 5, 7–9 (1955); S. REP. NO. 84-1095 (1955), *as reprinted in* 1956 U.S.C.C.A.N. 2482, 2483; LAMB, *supra* note 99, at 173–77. In 1956, there were 163 companies controlling one or more banks, but only eighteen of those companies had registered with the FRB. H.R. REP. NO. 84-609, at 10; 102 CONG. REC. 6755 (1956) (remarks of Sen. Robertson).

[142] LAMB, *supra* note 99, at 99–103, 117–23.

[143] H.R. REP. NO. 84-609, at 4 (1955); 102 CONG. REC. 6755 (1956) (remarks of Sen. Robertson, stating that Transamerica controlled banking assets of $2.5 billion and nonbanking assets of $1 billion); *id.* at 6859 (remarks of Sen. Douglas) (stating that Transamerica purchased ten banks in 1956).

[144] H.R. REP. NO. 84-609, at 10.

[145] Bank Holding Company Act, Pub. L. No. 84–511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841–1849).

force them to divest their nonfinancial activities.[146] The original BHC Act (1956 Act) applied to all companies controlling two or more banks (multibank holding companies). Section 4(a) of the 1956 Act prohibited multibank holding companies from acquiring nonbanking firms and required such holding companies to divest all nonbanking subsidiaries within two years after becoming subject to the BHC Act.[147] The prohibition and divestment mandates in section 4(a) were subject to several exceptions contained in section 4(c). The most important of those exceptions was set forth in section 4(c)(8), which permitted multibank holding companies to own nonbanking subsidiaries if their activities were found by the FRB to be "so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto."[148]

Thus, the 1956 Act was intended, among other things, to prevent companies from controlling both banks and commercial firms.[149] The 1956 Act therefore represented a powerful statement of Congress's intention to separate banking and commerce.[150] However, the 1956 legislation contained a major loophole, because it did not apply to one-bank holding companies.[151]

b. The 1970 Amendments to the BHC Act

Until the mid-1960s, the one-bank loophole was not considered significant, because most one-bank holding companies were small firms that controlled small banks and did not have a significant presence in either banking or nonbanking markets.[152] Beginning in the late 1960s, however, large banks began to organize one-bank holding companies in order to engage in nonbanking activities that were prohibited to multibank holding

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[146] *See, e.g.*, S. REP. NO. 84-1095 (1955), *as 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. . . . [B]ank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.").

[147] BHC Act § 4(a) (codified as amended at 12 U.S.C. § 1843(a) (2000)).

[148] BHC Act § 4(c)(8) (codified as amended at 12 U.S.C. § 1843(c)(8) (2000)).

[149] *See* 102 CONG. REC. 6755 (1956) (remarks of Sen. Robertson) (stating that the 1956 Act was intended to ensure that bank holding companies should only be permitted to engage in "banking activities" and "functions closely related to banking which are essential for their efficient operation"). As required by the 1956 Act, Transamerica divested all of its subsidiary banks in 1958 because it decided to retain its commercial businesses. LAMB, *supra* note 99, at 124–25.

[150] MCCOY, *supra* note 51, § 4.01 (stating that the 1956 Act "cemented the wall between banking and commerce by limiting nonbank activities by bank holding companies to activities that are 'closely related to banking,' thereby making it impossible for banks to acquire significant equity stakes in American industry"); ROE, *supra* note 70, at 98–99, 191–93 (discussing the impact of the 1956 Act in separating banking and commerce); *see also* S. REP. NO. 91-1084 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5519, 5520 (stating that the 1956 Act was adopted to prevent "a departure from the established policy of separating banking from other commercial enterprises").

[151] LITAN, *supra* note 91, at 30; Shull, *Separation Issues*, *supra* note 70, at 11.

[152] S. REP. NO. 91-1084 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5519, 5520–21; Shull, *Separation Issues*, *supra* note 70, at 11.

companies under section 4 of the 1956 Act. By 1970, the six largest banks in the nation had formed one-bank holding companies.[153] In addition, "many significant nonbank corporations, including major conglomerates, began acquiring one bank, thus mixing banking and nonbanking in complete contravention of the purpose of both Federal banking laws going back to the 1930's and the [1956 Act]."[154] Two large conglomerates that acquired banks and attracted Congress's attention were Sperry & Hutchinson, which owned three department stores and companies that manufactured carpets, furniture and textiles, and Montgomery Ward, which operated one of the largest chains of retail stores in the nation.[155]

In 1970, Congress amended the BHC Act to extend its provisions to one-bank holding companies.[156] Congress amended section 4(c)(8) of the Act, but the revised statute maintained the prohibition on ownership of nonbanking companies that were not "closely related" to banking.[157] Congress determined that the 1970 amendments were necessary "to continue our long-standing policy of separating banking and commerce."[158] The 1970 amendments reflected Congress's view that a strict separation of banking and commerce was needed for two principal reasons:

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[153] S. REP. NO. 91-1084, *as reprinted in* 1970 U.S.C.C.A.N. at 5521; *see also* 116 CONG. REC. 14819 (1970) (remarks of Sen. Brooke, stating that 397 one-bank holding companies were engaged in ninty-nine nonfinancial activities, including mining, oil and gas development, manufacturing, real estate, and retail and wholesale sales of goods); LITAN, *supra* note 91, at 31 (recognizing that in the mid-1960s many banks and nonbanking firms organized one-bank holding companies and that by 1970 over 700 such companies had been formed); Shull, *Separation Issues*, *supra* note 70, at 11–12.

[154] H.R. REP. NO. 91-1747 (1970) (Conf. Rep.), *as reprinted in* 1970 U.S.C.C.A.N. 5561, 5562 (statement of House managers); *see also* LITAN, *supra* note 91, at 31 (noting the expansion of BHCs into the nonbanking sphere).

[155] 115 CONG. REC. 32895 (1969) (remarks of Rep. Patman); *id.* at 32903 (remarks of Rep. Moorhead); *id.* at 33127 (remarks of Rep. Reuss); 116 CONG. REC. 32105–06 (1970) (remarks of Sen. Proxmire).

[156] Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, §§ 101–103, 84 Stat. 1760, 1760–63 (codified as amended at 12 U.S.C. §§ 1841–1843); *see* LITAN, *supra* note 91, at 31 (discussing 1970 amendments). With certain limited exceptions, the 1970 amendments required all one-bank holding companies to bring their nonbanking activities into conformity with section 4 of the BHC Act and to divest all nonconforming activities by December 31, 1980. *See* H.R. REP. NO. 91-1747, *as reprinted in* 1970 U.S.C.C.A.N. 5661, 5562, 5573–79 (statement of House managers); 116 CONG. REC. 42423, 42425–26 (1970) (remarks of Sen. Sparkman).

[157] As amended in 1970, section 4(c)(8) provided that bank holding companies could own companies "the activities of which the [FRB] . . . has determined . . . to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." Bank Holding Company Act Amendments of 1970 § 103(4), 12 U.S.C. § 1843(c)(8). The 1970 amendment eliminated the words "the business of" that previously appeared before the clause "banking or managing or controlling banks." The removal of those words was intended to make clear that nonbanking activities would be permissible as long as they were "closely related" to banking in general. Under the revised statute, nonbanking activities did not have to be "closely related" to specific activities that were conducted by subsidiary banks within the same holding company. *See* H.R. REP. NO. 91-1741 (1970) (Conf. Rep.), *as reprinted in* 1970 U.S.C.C.A.N. at 5566–67; 116 CONG. REC. 42425–26 (1970) (remarks of Sen. Sparkman).

[158] S. REP. NO. 91-1084 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5519, 5522.

> (1) to prevent undesirable concentrations of economic and financial power,[159] and
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> (2) to prevent banks affiliated with commercial firms from engaging in activities that would threaten the financial system or distort the economy, such as (A) making unsound loans to support their commercial affiliates, (B) refusing to make loans to competitors of their commercial affiliates, or (C) requiring borrowers to do business with their commercial affiliates as a condition of obtaining loans.[160]

c. The Competitive Equality Banking Act of 1987

Although the 1970 amendments to the BHC Act brought one-bank holding companies within the scope of the Act, the amendments also created a new loophole by changing the definition of "bank." Prior to 1970, the definition of "bank" in the BHC Act included all banks that accepted demand deposits.[161] The 1970 amendments narrowed that definition to include only banks that both accepted deposits and made commercial loans.[162] It was anticipated that this definitional change would exempt only one institution from the BHC Act—*viz.*, the Boston Safe Deposit and Trust Co., which accepted demand deposits but did not make any commercial loans.[163] During the 1970s, few other institutions sought to take advantage of this "nonbank bank loophole."[164]

However, commercial conglomerates, securities firms and insurance companies acquired FDIC-insured banks in the 1980s and caused those banks to stop engaging in one of the designated functions, thereby avoiding regulation under the BHC Act. By 1987, two major retailers—Sears and J.C. Penney—and many other large commercial firms owned FDIC-insured "nonbank banks."[165] Congress responded to the nonbank bank

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[159] *See, e.g.*, *id.* (quoting 1969 testimony of FRB chairman William Martin, who warned that "[i]f we allow the line between banking and commerce to be eased, we run the risk of cartelizing the economy"); H.R. REP. NO. 91-617 (1970) (Conf. Rep.) (statement of House managers), *as reprinted in* 1970 U.S.C.C.A.N. 5561, 5562 (quoting President Nixon's message to Congress on Mar. 24, 1969, requesting extension of the BHC Act to one-bank holding companies in order to prevent "the formation of a relatively small number of power centers dominating the American economy").

[160] S. REP. NO. 91-1084, *as reprinted in* 1970 U.S.C.C.A.N. 5519, 5521–22 (quoting testimony by FRB chairman Martin); 115 CONG. REC. 32891 (1969) (remarks of Rep. Bennett); *id.* at 32894 (remarks of Rep. Patman); *id.* at 32903 (remarks of Rep. Moorhead); 116 CONG. REC. 14818 (1970) (remarks of Sen. Brooke).

[161] *See* S. REP. NO. 89-1179 (1966), *as reprinted in* 1966 U.S.C.C.A.N. 2385, 2391 (discussing the definition of "bank" in the BHC Act as amended in 1966).

[162] Bank Holding Company Act Amendments of 1970 § 101(c), 12 U.S.C. § 1841(c).

[163] S. REP. NO. 100-19, at 5 (1987), *as reprinted in* 1987 U.S.C.C.A.N. 489, 495; 116 CONG. REC. 25848 (1970) (article by Frank V. Fowlkes, published in the National Journal on July 18, 1970, appended to remarks by Rep. Gonzalez); Shull, *Separation Issues*, *supra* note 70, at 12–13 n.47.

[164] *See* S. REP. NO. 100-19, at 5, *as reprinted in* 1987 U.S.C.C.A.N. at 495.

[165] *Id.* at 5–6, *as reprinted in* 1987 U.S.C.C.A.N. at 495–96; *see also* 133 CONG. REC. S3810 (daily ed. Mar. 25, 1987) (remarks of Sen. Graham) (stating that 169 "nonbank banks" were in

movement by passing the Competitive Equality Banking Act of 1987 (CEBA),[166] which closed the nonbank bank loophole as of March 5, 1987.[167] CEBA redefined the term "bank" in the BHC Act to include all FDIC-insured banks (with certain limited exceptions discussed below), as well as other institutions that both accept demand deposits and engage in commercial lending.[168] Thus, companies acquiring FDIC-insured banks after March 5, 1987, were required to comply with the BHC Act, including the limitations on non-banking activities under section 4.[169]

Congress grandfathered companies that owned nonbank banks as of March 5, 1987, but Congress imposed severe restrictions on those companies and their subsidiary banks. For example, grandfathered holding companies could not acquire any additional banks, and grandfathered nonbank banks could not engage in any new activities or enter into any new cross-marketing arrangements with their affiliates for nonbanking products or services that were not permissible under the BHC Act. In addition, grandfathered nonbank banks were subject to a growth limitation of 7% per year.[170] Due in part to the operational constraints imposed by CEBA, the number of "nonbank banks" declined from 169 in 1987 to 28 in 1992, 20 in 1995 and only 8 in 2005.[171]

The Senate committee report on CEBA declared that "[n]onbank banks undermine the principle of separating banking and commerce, a policy that has long been the keystone of our banking system. . . . The separation of banking from commerce helps ensure that banks allocate credit impartially, and without conflicts of interest."[172] The committee report also expressed concern about the possibility that a large retailing firm might acquire a nonbank bank and then deny credit to competing dealers.[173] The report

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existence and applications had been filed to acquire more than 200 additional nonbank banks); LITAN, *supra* note 91, at 46–47 (discussing the ability of nonfinancial companies to conduct banking activities by using "the nonbank bank loophole"); Shull, *Separation Issues*, *supra* note 70, at 12–13.

[166] Competative Equality Banking Act of 1987 (CEBA), Pub. L. No. 100-86, 101 Stat. 552 (codified in scattered sections of 12 U.S.C.).

[167] S. REP. NO. 100-19 (1987), at 2–3, *as reprinted in* 1987 U.S.C.C.A.N. at 492–93; H.R. REP. NO. 100-261, at 119–20 (1987) (Conf. Rep.), *as reprinted in* 1987 U.S.C.C.A.N. 588, 589.

[168] CEBA § 101(a)(1) (codified as amended at 12 U.S.C. § 1841(c)); H.R. REP. NO. 100-261, at 119–20 (1987), *as reprinted in* 1987 U.S.C.C.A.N. at 589.

[169] S. REP. NO. 100-19, at 2–6, *as reprinted in* 1987 U.S.C.C.A.N. at 492–96.

[170] *Id.* at 11–13, 31–35, *as reprinted in* 1987 U.S.C.C.A.N. at 501–03, 521–25; *see also* H.R. REP. NO. 100-261, at 123–29, *as reprinted in* 1987 U.S.C.C.A.N. at 593–99.

[171] *See* 133 CONG. REC. S3810 (daily ed. Mar. 25, 1987) (remarks of Rep. Graham, providing figure for 1987); GAO-ILC REPORT, *supra* note 39, at 69 (providing figure for 2005); Federal Deposit Insurance Corporation, *A Unified Federal Charter for Banks and Savings Institutions*, FDIC BANKING REV., 1997 No. 1, at 1, 14–15 (providing figure for 1995); William Jackson, *Mixing Banking and Commerce Using Federal Deposit Insurance: Industrial Banks and Nonbank Banks*, CONG. RES. SERV. REP. 93-769 E, Aug. 26, 1993, at n.15 and accompanying text (providing figure for 1992).

[172] S. REP. NO. 100-19, at 8, *as reprinted in* 1987 U.S.C.C.A.N. at 498.

[173] The Senate committee report explained that commercial ownership of nonbank banks "raises the risk that the banks' credit decisions will be based not on economic merit but on the business

maintained that the nonbank bank loophole must be closed in order to "minimize the concentration of financial and economic resources" and to enhance "the safety and soundness of our financial system."[174] By closing that loophole, CEBA strongly reaffirmed the general policy in favor of separating banking and commerce that Congress had implemented in 1956 and 1970.[175]

CEBA also added a new section 23B to the Federal Reserve Act, which imposes additional restrictions on transactions between FDIC-insured banks and their affiliates.[176] Section 23B requires a broad range of transactions between a bank and its affiliate to be conducted in accordance with terms and conditions that are (i) at least as favorable to the bank as those prevailing at the time for comparable transactions involving nonaffiliated companies or (ii) in the absence of comparable transactions, those that would be offered in good faith to nonaffiliated companies.[177]

CEBA excluded limited-purpose trust companies and credit card banks from the definition of "bank" under the BHC Act, thereby exempting the parent companies of such institutions from compliance with that Act.[178] However, CEBA imposed stringent limitations that effectively preclude such trust companies and credit card banks from engaging in a retail banking business or from making commercial loans.[179]

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strategies of their corporate parents." *Id.* The report then quoted the following hypothetical posed by FRB chairman Paul Volcker:

> [s]uppose the local appliance dealer comes in to ask for loans from a bank run by a large retail chain. I suspect the branch manager isn't going to be very happy to provide the money. . . . If he does [make the loans], I suspect he is going to find himself selling shoes . . . before long.

Id. The report also quoted a similar concern expressed by the same committee in 1970 about the risk that banks controlled by merchandising firms would engage in discriminatory lending to (i) penalize competing dealers and (ii) pressure borrowers into doing business with the banks' affiliates. *Id.* at 9, *as reprinted in* 1987 U.S.C.C.A.N. at 499.

[174] *Id.* at 2, 9, *as reprinted in* 1987 U.S.C.C.A.N. at 492, 499.

[175] During the floor debates over CEBA, members of Congress emphasized that the nonbank bank loophole must be closed in order to preserve the general policy of separating banking and commerce and to ensure parity of regulatory treatment for all companies that controlled FDIC-insured banks. *See, e.g.*, 133 CONG. REC. S3800–01 (daily ed. Mar. 25, 1987) (remarks of Sen. Proxmire); *id.* at S3810 (remarks of Sen. Graham); *id.* at S3816–17 (remarks of Sen. Heinz); *id.* at S3957 (remarks of Sen. Cranston); 133 CONG. REC. S4051–52 (daily ed. Mar. 27, 1987) (remarks of Sen. Proxmire); *id.* at S4057 (remarks of Sen. Durenberger); *id.* at S4058 (remarks of Sen. Glenn); *id.* at S4059–60 (remarks of Sen. Leahy); 133 Cong. Rec. H6944–02 (Aug. 3, 1987), *available at* 1987 WL 943889 (Cong. Rec.) (remarks of Reps. Vento, Parris, Wylie, Vento and Wortley).

[176] CEBA § 102(a), 12 U.S.C. § 371c-1 (2000).

[177] For discussions of section 23B, see H.R. REP. NO. 100-261, at 132–33 (1987) (Conf. Rep.), *as reprinted in* 1987 U.S.C.C.A.N. 588, 601–02; FEIN, *supra* note 127, § 2.02[B][3].

[178] CEBA § 101(a)(1) (codified as amended at 12 U.S.C. § 1841(c)(2)(D), (F) (2000)).

[179] *Id.* In order to qualify for CEBA's exemption, a trust company must accept all or substantially all of its deposits as trust funds, may not allow its insured deposits to be marketed by or through an affiliate, may not accept demand deposits or transaction deposits similar to NOW accounts, may not make commercial loans, and may not obtain payment-related services or discount window borrowing privileges from the FRB. H.R. REP. NO. 100-261, at 120 (Conf. Rep.), *as reprinted in* 1987 U.S.C.C.A.N. at 589. Similarly, in order to rely on CEBA's exemption a credit card bank may not accept demand deposits, transaction accounts, or time deposits in amounts smaller than $100,000, may

In contrast, CEBA exempted ILCs from treatment as "banks" as long as they are chartered in a qualifying state and either do not accept demand deposits or maintain total assets of less than $100 million.[180] Thus, the parent companies of ILCs do not have to comply with the BHC Act even if their ILCs provide retail banking services (except for demand deposits) and make commercial loans. The legislative history of CEBA does not explain why Congress gave ILCs much more leeway than trust companies or credit card banks.[181] However, former Senator Jake Garn of Utah, a co-sponsor of the ILC exemption, explained his personal view of that exemption when he testified during the FDIC's public hearings on Wal-Mart's application. Senator Garn declared that he would strongly oppose any attempt by Wal-Mart to "expand their application" to offer retail banking services at Wal-Mart stores because

> it was never my intent, as the author of this particular section, that any of these industrial banks be involved in retail operations . . . . I would be the most vociferous opponent of that because that was not my intent at the time CEBA was passed.[182]

Senator Garn's testimony indicates a congressional understanding in 1987 that ILCs would not be used as a platform for large commercial firms to offer full-service banking to consumers at the parent companies' retail outlets. In 1987, ILCs were small, state-chartered institutions that had limited deposit-taking powers and engaged principally in making consumer loans to middle-income and lower-income individuals. Thirteen ILCs failed during 1982–1984, and Utah imposed a moratorium on chartering new ILCs in 1987.[183] The total assets of all ILCs in 1987 were only $4.2

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not maintain more than one office that accepts deposits, and may not make commercial loans. *Id.* at 121, *as reprinted in* 1987 U.S.C.C.A.N. at 590.

[180] CEBA § 101(a)(1) (codified as amended at 12 U.S.C. § 1841(c)(2)(H) (2000); *see also supra* notes 40–43 and accompanying text (discussing the ability of ILCs to avoid coverage under the BHC Act if they meet certain conditions).

[181] The current exemption for ILCs was contained in a manager's amendment, which was co-sponsored by Senators William Proxmire and Jake Garn and was approved during the Senate floor debates on CEBA. 133 CONG. REC. S3810, S3813 (daily ed. Mar. 25, 1987) (remarks of Sen. Proxmire). Senators who discussed the ILC exemption and the conference committee report simply summarized the statutory terms of the ILC exemption and did not explain its underlying purpose or intended scope. *See id.* at S3813 (remarks of Sen. Proxmire); 133 CONG. REC. S3957 (daily ed. Mar. 26, 1987) (colloquy between Sen. Inouye and Sen. Proxmire); *see also* H.R. REP. NO. 100-261, at 121, *as reprinted in* 1987 U.S.C.C.A.N. at 592 (explaining the exemption for ILCs in section 2(c)(2)(H) of the BHC Act).

[182] *Testimony of Sen. Edwin J. "Jake" Garn*, Wal-Mart Hearings, *supra* note 12, at 8, 12 (Panel 8, Apr. 10, 2006) (transcript of oral testimony of Sen. Edwin J. "Jake" Garn).

[183] *Hearing on Industrial Loan Companies Before the Subcomm. on Fin. Insts. & Consumer Credit and the Comm. on Fin. Servs.*, 109th Cong. (2006) (testimony of Scott G. Alvarez, General Counsel, Federal Reserve Board), *available at* http://www.federalreserve.gov/boarddocs/testimony/2006/20060712/default.htm; *As Good as Their Word*, FORBES, Feb. 25, 1985, at 52, *available at* LEXIS, News Library, FORBES File; Bill McConnell, *Utah to End Freeze on Charters for Industrial*

billion, and the largest ILC had less than $420 million of assets.[184] In 1993, a Congressional Research Service report stated that ILCs played only a "minor" role in the U.S. financial system.[185]

However, ILCs have expanded rapidly in recent years, due in part to the liberalization of laws governing ILCs in Utah and California. Those laws effectively give ILCs parity with state-chartered commercial banks (except for the ability to offer demand deposits).[186] In addition, a 1999 federal statute encouraged commercial firms (including Wal-Mart) to seek ILC charters, because that law barred commercial firms from making any further acquisitions of thrift institutions.[187] Between the end of 1987 and 2006, total assets held by ILCs grew from $4.2 billion to $155 billion. Currently, the largest ILC (owned by Merrill Lynch) holds more than $60 billion of assets, and commercial firms own eighteen ILCs.[188]

Thus, the ILC industry has changed dramatically since Congress enacted CEBA in 1987. The FDIC recently stated that the business plans submitted by Wal-Mart, Home Depot and other proposed or existing commercial owners of ILCs "differ substantially from the consumer lending focus of the original industrial banks."[189] Like the one-bank loophole left open in 1956 and the nonbank bank loophole left open in 1970, it appears that Congress did not appreciate the potential impact of the ILC exemption when it passed CEBA in 1987.

4. *Limitations on Bank Affiliations and Powers, 1989–1999*

a. The Thrift Crisis and the 1989 Rescue Legislation

Many factors contributed to the collapse of the thrift industry during the 1980s. Most commentators have agreed that a combination of events caused the thrift crisis to become much worse in the mid-1980s. During 1979–1982, inflationary pressures and the FRB's monetary policy created an interest rate mismatch, which forced savings associations to pay interest

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Loan Companies, AM. BANKER, Apr. 3, 1997, at 3, *available at* LEXIS, News Library, AMBNKR File (stating that Utah imposed a "freeze" on new ILC charters in 1987 "following a wave of failures").

[184] FDIC Moratorium Notice, *supra* note 13, at 43,482.

[185] Jackson, *supra* note 171, at n.7 and accompanying text (stating that ILCs had only $7 billion of assets at the end of 1992, while U.S. commercial banks and trust companies held $3.5 trillion of assets).

[186] Utah liberalized its ILC statutes and authorized the chartering of new ILCs in 1997. *See* McConnell, *supra* note 183. California passed a statute in 2000 that gave ILCs virtual parity with state-chartered commercial banks (except for the ability to accept demand deposits). GAO-ILC REPORT, *supra* note 39, at 24. For discussions of the Utah and California laws governing ILCs, see *id.* at 21–22, 24–25; FDIC Proposed Rule on Consolidated Supervision, *supra* note 47, at 5221 n.32.

[187] *See infra* notes 263–69 and accompanying text (discussing 1999 legislation and its impact in barring Wal-Mart from acquiring a thrift institution); *see also* Blair, *supra* note 52, at 97–98, 112–13 (noting impact of 1999 legislation in establishing the ILC charter as the only means for a commercial firm to acquire an FDIC-insured depository institution).

[188] Statement of Douglas H. Jones, *supra* note 42 (providing information regarding Merrill Lynch's ILC); FDIC Moratorium Extension Notice, *supra* note 5, at 5291.

[189] FDIC Moratorium Extension Notice, *supra* note 5, at 5291.

on their deposits that exceeded the interest they earned on their residential mortgage loans.[190] During 1981–1982, most thrift institutions recorded losses.[191] By the end of 1982, the thrift industry's tangible net worth was "virtually zero," having declined from 5.3% in 1980 to 0.5% in 1982.[192]

Congress responded to the plight of the thrift industry by passing statutes in 1980 and 1982 that deregulated interest rates on deposits, reduced capital requirements, increased deposit insurance coverage from $40,000 to $100,000 per account, and expanded the powers of federal savings associations.[193] Some of the new or expanded powers were helpful (e.g., the ability to offer adjustable-rate mortgages),[194] but others were highly risky. For example, the 1982 statute expanded the commercial real estate lending authority of federal savings associations from 20% to 40% of their assets, allowed them to make commercial loans up to 10% of their assets, and permitted them invest up to 3% of their assets in service corporations that could engage in any type of activity.[195] Unfortunately, the Federal Home Loan Bank Board (FHLBB) failed to exercise strict supervision over these new powers. Instead, the FHLBB followed a general policy of laxity and forbearance because it hoped that the newly-granted powers would enable thrifts to grow out of their problems.[196]

The increase of federal deposit insurance coverage to $100,000 per account and the FHLBB's removal of limitations on brokered deposits enabled thrifts to raise huge amounts of funds by offering deposits nationwide through securities firms and other deposit brokers.[197] Brokered deposits in the thrift industry grew from $3 billion to $30 billion during 1982–1984.[198] The thrifts that grew most rapidly during the mid-1980s

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[190] MARTIN LOWY, HIGH ROLLERS: INSIDE THE SAVINGS AND LOAN DEBACLE 14–17 (1991); LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION 67–71 (1991).

[191] LOWY, *supra* note 190, at 14; WHITE, *supra* note 190, at 70–71.

[192] 1 FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 169 (1997). Lawrence White argues that the thrift industry was in fact deeply insolvent by the end of 1982. WHITE, *supra* note 190, at 71, 94–95.

[193] KATHLEEN DAY, S&L HELL: THE PEOPLE AND THE POLITICS BEHIND THE $1 TRILLION SAVINGS AND LOAN SCANDAL 61, 67, 124 (1993); FED. DEPOSIT INS. CORP., *supra* note 192, at 174–75 (discussing the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982); LOWY, *supra* note 190, at 19–20, 47; WHITE, *supra* note 190, at 74.

[194] WHITE, *supra* note 190, at 72–73.

[195] DAY, *supra* note 193, at 122–24; WHITE, *supra* note 190, at 73.

[196] S. REP. NO. 101-19, at 4, 9 (1989); FED. DEPOSIT INS. CORP., *supra* note 192, at 172–81; DAY, *supra* note 193, at 88–102, 125–26; LOWY, *supra* note 190, at 44–45, 50–52, 55–57, 90–98; WHITE, *supra* note 190, at 75–93, 112, 117. For example, in 1983 the FHLBB "issued a rule . . . [stating that federal savings associations could] invest up to 11% of their federally insured assets in high-yield, high-risk [debt] securities known as junk bonds." DAY, *supra* note 193, at 125.

[197] DAY, *supra* note 193, at 152; MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY 65–66 (1990) (discussing the changes that occurred to brokered funds and deposits).

[198] Day, *supra* note 193, at 153–54.

were also the institutions that tended to rely most heavily on brokered funds.[199]

In response to federal deregulation of the thrift industry, many states liberalized their own laws in order to keep state thrift charters attractive.[200] State laws in California, Florida and Texas removed virtually all limits on the authority of state-chartered thrifts to make commercial real estate loans and allowed them to invest (either directly or through service corporations) in real estate, junk bonds, derivatives, corporate stocks and a myriad of non-financial businesses such as casinos, hotels, ski resorts, thoroughbred horses, and windmill farms.[201] The expansion of federal and state powers and the availability of brokered deposits spurred a dramatic growth in the thrift industry. During 1982–1985, hundreds of new thrifts were chartered and total thrift assets increased by nearly 60%, more than twice the rate of asset growth for commercial banks.[202] Much of this growth took place in nontraditional assets, which thrifts acquired by exercising their newly-granted powers.[203] "By 1986, [residential mortgages accounted for] only 56 percent of total [thrift industry] assets . . . compared with 78 percent in 1981."[204]

Thrift institutions that aggressively expanded into nontraditional lines of business had a significantly higher failure rate compared to thrifts that maintained their primary focus on home mortgage lending. A 1989 General Accounting Office (GAO) study determined that twenty-six of the most costly thrift failures prior to October 1987 involved institutions that engaged in nontraditional activities, including loans for the acquisition, development and construction of real estate (ADC loans), investments in equity securities and junk bonds, and investments in service corporations that conducted non-financial activities.[205] Three other studies similarly found that the asset portfolios of failed thrifts contained higher-than-average percentages of commercial real estate loans, ADC loans and direct equity investments.[206] Many thrifts also failed after entering into illegal or

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[199] WHITE, *supra* note 190, at 103–04.

[200] H.R. REP. NO. 101-54, pt. 1, at 297 (1989), *as reprinted in* 1989 U.S.C.C.A.N. 86, 93 ("By 1984, more than one third of all states had granted their state-chartered thrifts investment powers beyond those permissible for federally-chartered institutions.").

[201] S. REP. NO. 101-19, at 8–9, 21 (1989); DAY, *supra* note 193, at 124–25; FED. DEPOSIT INS. CORP., *supra* note 192, at 176–77, 179–80, 400–01; LOWY, *supra* note 190, at 52–53; WHITE, *supra* note 190, at 73.

[202] FED. DEPOSIT INS. CORP., *supra* note 192, at 178 & tbl.4.3, 179; WHITE, *supra* note 190, at 100–04.

[203] WHITE, *supra* note 190, at 103–04.

[204] FED. DEPOSIT INS. CORP., *supra* note 192, at 179.

[205] U.S. GEN. ACCOUNTING OFFICE, THRIFT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES 26–30 (1989).

[206] WHITE, *supra* note 190, at 113–15, 116 tbl.6-12, 259–60.

unsound loans or other transactions with directors, officers, principal shareholders and their affiliates.[207]

Some of the largest and most costly thrift failures occurred at institutions that invested heavily in junk bonds underwritten by Michael Milken and Drexel Burnham Lambert. During the 1980s, Milken and Drexel sold $28 billion of junk bonds to forty-four thrifts that subsequently failed.[208] Milken and Drexel provided capital to many of those thrifts by underwriting offerings of junk bonds and other securities.[209] In return, Milken expected the same thrifts to buy junk bonds that Drexel underwrote for the purpose of financing hostile takeovers of large conglomerates and other publicly-traded companies.[210] After Drexel declared bankruptcy in 1990, federal regulators alleged that junk bonds sold by Milken and Drexel had inflicted $11 billion of losses on failed thrifts.[211] Losses on junk bonds were the primary cause of Columbia Savings's demise and also contributed to the failures of Centrust Bank, Imperial Federal Savings and Lincoln Savings.[212]

Nontraditional activities, junk bonds and abusive transactions with affiliates played major roles in the collapse of Lincoln Savings, the fourth most costly thrift failure.[213] Charles Keating and his holding company, American Continental Co. (ACC), bought Lincoln Savings in 1984 with funds provided by Milken and Drexel.[214] Keating quickly transformed

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[207] S. REP. NO. 101-19, at 9–10 (1989); U.S. GEN. ACCOUNTING OFFICE, *supra* note 206, at 19–20 ("Examiners found that 21 of 26 failed thrifts violated the regulation governing transactions with [insiders and other] affiliates . . . [and] 20 of 26 failed thrifts violated [rules] governing conflicts of interest . . . ."); WHITE, *supra* note 190, at 115–16; *see also* Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 909 & n.10, 910–11, 919 (D.D.C. 1990) (finding that a "tax sharing agreement" between Lincoln Savings and American Continental Company (ACC) violated a federal regulation restricting affiliate transactions and was used by ACC to extract more than $90 million in illegitimate payments from Lincoln Savings); MCCOY, *supra* note 51, § 4.02 (stating that "[l]oans to affiliates played a major role in the 1980s thrift crisis").

[208] DAY, *supra* note 193, at 391.

[209] *Id.* at 208, 330–31, 391; MAYER, *supra* note 197, at 172–73, 175; ROY C. SMITH, THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1960S, at 226–27 (1990).

[210] EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION 256–62, 271–80 (1999); LOWY, *supra* note 190, at 152–53, 156–58; MAYER, *supra* note 197, at 76-77, 172–75, 182–85, 280–81. According to Martin Mayer, thrift institutions provided "at least 15 percent of the [junk bond] buying power Drexel had controlled" during the 1980s. MAYER, *supra* note 197, at 281.

[211] 1 FED. DEPOSIT INS. CORP., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, 1980–1994, at 282 (1998). Milken and Drexel ultimately settled the claims asserted against them related to thrift failures by agreeing to pay federal regulators and a class of private litigants more than $2.2 billion. *Id.* at 283. Milken and Drexel had previously paid $1.25 billion to settle criminal and civil charges filed against them based on alleged securities law violations. DAY, *supra* note 193, at 391.

[212] DAY, *supra* note 193, at 330–31; LOWY, *supra* note 190, at 155–59; MAYER, *supra* note 197, at 183–85, 280–81; Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 356 n.591.

[213] *See* FED. DEPOSIT INS. CORP., *supra* note 192, at 282, 863 tbl.C.16.

[214] Lincoln Sav. & Loan Ass'n. v. Wall, 743 F. Supp. 901, 906–07 (D.D.C. 1990).

Lincoln from a traditional $1.1 billion thrift that had focused on home mortgages into a $6 billion institution that invested heavily in nontraditional assets, including ADC loans, unimproved real estate, hotels, casinos, stocks of companies that were targets of Drexel-financed takeovers, and junk bonds.[215] Lincoln financed much of its spectacular growth by selling brokered deposits.[216]

After acquiring control of Lincoln, Keating and ACC engaged in a series of manipulative transactions that resulted in (i) the creation of phony "profits" for Lincoln based on sham sales of assets to "straw" buyers, and (ii) the transfer of 40% of those "profits" from Lincoln to ACC pursuant to an abusive "tax sharing agreement."[217] Keating created Lincoln's fictitious "profits" by causing Lincoln to sell unimproved real estate and securities to "straw" buyers at artificially inflated prices.[218] In most cases, Lincoln funded the purchase price, either by making a reciprocal purchase of assets from the buyer (or its affiliate) or by making a loan, typically on a non-recourse basis, to the buyer (or its affiliate).[219] Lincoln's sham sales produced "profits" equal to the difference between the inflated sales price for each asset and its cost basis on Lincoln's books.[220]

Keating also caused Lincoln to enter into a tax sharing agreement with ACC. That agreement required Lincoln to transfer 40% of its accounting profits to ACC, even if Lincoln would not have owed any taxes on a stand-alone basis.[221] Lincoln transferred $94 million to ACC under the tax sharing agreement, even though Lincoln would have owed little or no taxes based on the results of its stand-alone operations during 1984–1987.[222] Thus, the agreement enabled ACC to extract large amounts of funds from Lincoln without any legal justification.[223]

By 1986, ACC and Lincoln were in deep financial trouble and desperately needed a new source of funds. To meet this need, ACC sold unsecured subordinated notes (in denominations of $1000) to Lincoln's

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[215] *Lincoln*, 743 F. Supp. at 906–08; DAY, *supra* note 193, at 207–10; MAYER, *supra* note 197, at 165-66, 169–86; *see also* LOWY, *supra* note 190, at 219 (citing a 1987 examination report stating that "sixty-two percent of Lincoln's assets . . . [consisted] in vacant land, hotels, ADC loans, junk bonds and equity securities.").

[216] The percentage of Lincoln's liabilities represented by brokered deposits rose from 2.6% in 1983 to 35% in 1988. DAY, *supra* note 193, at 210. "Because it was growing so fast . . . Lincoln paid more for its [brokered deposits] than almost any other S&L in the country." MAYER, *supra* note 197, at 182.

[217] *See infra* notes 218–23 and accompanying text.

[218] *Lincoln*, 743 F. Supp. at 911–12; LOWY, *supra* note 190, at 150; MAYER, *supra* note 197, at 179–80.

[219] *Lincoln*, 743 F. Supp. at 912–15; MAYER, *supra* note 197, at 179–80.

[220] *Lincoln*, 743 F. Supp. at 911–13; MAYER, *supra* note 197, at 179–80.

[221] *Lincoln*, 743 F. Supp. at 908–09; LOWY, *supra* note 190, at 149–50; MAYER, *supra* note 197, at 204–05.

[222] *Lincoln*, 743 F. Supp. at 909–10; MAYER, *supra* note 197, at 205.

[223] *Lincoln*, 743 F. Supp. at 909–11; MAYER, *supra* note 197, at 204–05.

customers at Lincoln's branches. ACC's and Lincoln's employees urged customers to buy ACC's uninsured notes instead of insured certificates of deposit, and successful employees received bonuses. Some 23,000 individuals purchased more than $230 million of ACC's notes, which became worthless when ACC declared bankruptcy in April 1989.[224] The FHLBB finally seized control of Lincoln on April 14, 1989, at least two years too late in the view of some analysts.[225] Lincoln's failure ultimately cost the federal government $2.7 billion.[226]

Congress responded to the thrift debacle by enacting the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[227] FIRREA authorized a taxpayer-funded bailout of the thrift industry[228] and also mandated sweeping changes in the supervision and regulation of thrifts.[229] In addition, several provisions of FIRREA strictly limited the authority of thrift institutions to engage in commercial lines of businesses or to be associated with commercial firms. First, because commercial real estate loans were a major cause of thrift losses, Congress restricted the authority of federal savings associations to make such loans.[230] Second, because nontraditional activities inflicted heavy losses on state-chartered savings associations, FIRREA generally barred state-chartered thrifts from engaging in activities or from making investments that exceed the authority of federal savings associations.[231] Third, because of losses resulting from

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[224] DAY, *supra* note 193, at 341–42, 346–48; MAYER, *supra* note 197, at 167–68, 203–06, 287.

[225] DAY, *supra* note 193, at 338–49; LOWY, *supra* note 190, at 147–52, 218–21; MAYER, *supra* note 197, at 206–24. In *Lincoln Savings & Loan Ass'n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990), the court dismissed Lincoln's and ACC's challenge to the federal takeover of Lincoln. The court found that the FHLBB "acted properly in placing Lincoln first in conservatorship and then in receivership." *Id.* at 906. The court noted, however, that the FHLBB probably should have taken vigorous enforcement measures against Lincoln much earlier. *Id.* at 920 n.31.

[226] FED. DEPOSIT INS. CORP., *supra* note 211, at 863 tbl.C.16.

[227] Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified as amended in various sections of 12 U.S.C.).

[228] During 1980–1994, 1295 thrifts with total assets of $621 billion either failed or received federal financial assistance. FIRREA originally budgeted $50 billion to complete the rescue of the thrift industry, on top of the $38 billion that had been committed prior to 1989. However, the total cost of resolving failed thrifts ultimately grew to $161 billion, of which about $132 billion was paid by taxpayers. FED. DEPOSIT INS. CORP., *supra* note 192, at 187; FED. DEPOSIT INS. CORP, *supra* note 211, at 4, 28–29, 851 tbl.C.8; WHITE, *supra* note 190, at 176, 183–84, 196–97.

[229] Among other things, FIRREA abolished the FHLBB (which had been an independent agency) and transferred its supervisory functions to the OTS, a bureau of the Treasury Department. In addition, FIRREA abolished the Federal Savings and Loan Insurance Corporations (FSLIC) and transferred to the FDIC the responsibility for insuring the deposits of thrifts. For descriptions of FIRREA's supervisory and regulatory provisions, see H.R. REP. NO. 101-222, at 393–408 (1989) (Conf. Rep.); MAYER, *supra* note 197, at 261, 280–83; WHITE, *supra* note 190, at 178–80.

[230] FIRREA § 301, 12 U.S.C. § 1464(c)(2)(B) (2000) (limiting commercial real estate loans to 400% of a thrift's capital); *see also* H.R. REP. NO. 101-222, at 408 (1989) (Conf. Rep.); S. REP. NO. 101-19, at 8, 18–19 (1987).

[231] Under FIRREA, state-chartered thrifts are generally barred from engaging as principal in activities or from making investments that are not allowed to federal savings associations. However, the FDIC may permit a state-chartered thrift to engage in an activity or to invest in a service corporation that exceeds the authority of a federal thrift, if (i) the thrift satisfies applicable capital

junk bond investments, Congress prohibited both federal and state-chartered thrifts from making further investments in junk bonds and forced them to divest their existing junk bond investments by July 1, 1994.[232]

Fourth, because of the injuries caused by affiliates, FIRREA imposed tighter restrictions on transactions between thrifts and their affiliates. Congress required all thrift institutions to comply with sections 23A and 23B of the Federal Reserve Act. In addition, Congress barred thrifts from extending credit to affiliates engaged in activities that would not be allowed to bank holding companies.[233] Thus, unlike today's commercially-owned ILCs, a thrift may not make any loans to an affiliate engaged in commercial activities. Fifth, FIRREA imposed more stringent limitations on savings and loan holding companies that owned only one thrift institution (unitary SLHCs). Among other things, Congress required any thrift owned by a unitary SLHC to comply with an enhanced "qualified thrift lender" (QTL) test if the SLHC engaged in activities beyond those permitted to bank holding companies.[234]

b. The Treasury Department's 1991 Financial Modernization Plan and Congressional Responses during 1991–1999

In February 1991, the Treasury Department issued a comprehensive plan to modernize the financial services industry.[235] The Treasury issued its plan at a time when the banking industry faced its most severe crisis since the Great Depression.[236] The Treasury report contained sweeping recommendations for reforms in the deposit insurance system and in the

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requirements and (ii) the FDIC has determined that the activity or service corporation does not pose a significant risk to the deposit insurance fund. FIRREA § 222, 12 U.S.C. § 1831e(a)–(c) (2000); *see also* H.R. REP. NO. 101-222, at 400–01 (1989) (Conf. Rep.).

[232] FIRREA § 222, 12 U.S.C. § 1831e(d) (2000); *see also* H.R. REP. NO. 101-222, at 402 (1989) (Conf. Rep.); MAYER, *supra* note 197, at 280–81.

[233] FIRREA § 301, 12 U.S.C. § 1468(a) (2000); H.R. REP. NO. 101-222, at 408 (1989) (Conf. Rep.); *see also supra* notes 131, 176–77 and accompanying text (discussing sections 23A and 23B).

[234] FIRREA § 301, 12 U.S.C. § 1467a(m). Since 1967, federal law has permitted unitary SLHCs to engage in nonfinancial activities that are not permissible for bank holding companies. Congress did not close this "loophole" during the 1970s or 1980s, evidently because Congress wanted to encourage commercial firms to acquire thrifts and thereby inject additional equity capital into a troubled industry. James B. Thomson, *Unitary Thrifts: A Performance Analysis*, 37 FED. RES. BANK OF CLEVE. ECON. REV., Second Quarter 2001, at 2, 2–3. Beginning in 1987, however, Congress required any thrift owned by a unitary SLHC to meet the QTL test if its parent holding company engages in nonfinancial activities. In general, the QTL requires a thrift to maintain a substantial majority of its assets in residential mortgage loans and other housing-related assets. *See* S. REP. NO. 100-19, at 38–40 (1987); MCCOY, *supra* note 51, § 4.04. For a discussion of the enhanced QTL imposed by FIRREA, see H.R. REP. NO. 101-54, pt. I, at 351–52 (1989).

[235] U.S. DEPT. OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

[236] For a comprehensive overview of the banking crisis of 1980–1994, see FED. DEPOSIT INS. CORP., *supra* note 192. For additional discussions of significant aspects of that crisis, see Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 964–66, 984–86, 989–94, 1000–01 (1992); Wilmarth, *supra* note 212, at 304–05, 313–16.

supervision of banks.[237] Congress passed legislation in December 1991 that adopted many of the Treasury's recommendations with regard to deposit insurance and bank supervision.[238] Among other things, the Treasury report recommended that FDIC-insured state banks should generally be prohibited from engaging as principals in activities or from making investments that are not permissible for national banks.[239] In accordance with that recommendation, the 1991 statute extended to state banks the same type of activity and investment limitations that Congress had imposed on state-chartered thrifts in 1989.[240] As a result of the 1989 and 1991 legislation, all FDIC-insured banks and thrifts are effectively barred from engaging or investing in nonfinancial businesses.[241]

In addition to its reform proposals for deposit insurance and bank supervision, the Treasury report contained three major recommendations for modernizing the financial services industry. First, the report called for legislation authorizing interstate acquisitions of banks by bank holding companies and interstate branching by banks. Second, the report urged Congress to authorize financial holding companies that could own banks, securities firms and insurance companies. Third, the report argued that commercial firms should be allowed to own financial holding companies.[242]

Congress implemented the Treasury report's first recommendation in 1994, when it passed legislation authorizing bank holding companies to make interstate acquisitions of banks and also authorized banks to establish interstate branches.[243] Congress adopted the second recommendation in

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[237] U.S. DEPT. OF THE TREASURY, *supra* note 235, at 16–48.

[238] *See* Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[239] U.S. DEPT. OF THE TREASURY, *supra* note 235, at 47. The Treasury report pointed out that "[n]ational banks are not permitted to make direct equity investments with insured deposits in commercial real estate and other commercial enterprises." *Id.* at 48. The report acknowledged that broader activities and investments by state banks "have not yet caused the same kind of losses as state-chartered thrifts. Indeed, many state-chartered banks have exercised their broader authorities both prudently and profitably." *Id.* at 47–48. Nevertheless, the Treasury report concluded that "direct equity investment remains a greater risk to the federal deposit insurance fund than traditional bank loans," and "there may be instances where unusual or additional risk is present that creates federal exposure" when state banks exercise broader powers. *Id.* at 48.

[240] Under the 1991 law, a state bank may not engage as principal (either directly or through a subsidiary) in any activity that is not permissible for national banks unless the state bank satisfies applicable capital requirements and the FDIC has determined that the activity does not present a significant risk to the deposit insurance fund. In addition, with certain exceptions, a state bank may not make any investment that is not allowed for national banks. Federal Deposit Insurance Corporation Improvement Act of 1991, § 303, 12 U.S.C. § 1831a (2000); *see also* H.R. REP. NO. 102-330, at 135–36 (1991), *as reprinted in* 1991 U.S.C.C.A.N. 1901, 1948–49.

[241] *See* MCCOY, *supra* note 51, § 3.02[1]; Shull, *Banking and Commerce*, *supra* note 70, at 265–66.

[242] U.S. DEPT. OF THE TREASURY, *supra* note 235, at 49–61; *see also id.* at chs. XVII–XVIII (providing supporting analysis for the Treasury's recommendations on financial modernization).

[243] *See* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994). For discussions of this statute and its encouragement of greater

1999, when it passed the Gramm-Leach-Bliley Act (GLBA). GLBA repealed sections 20 and 32 of the Glass-Steagall Act[244] and authorized banks, securities firms and insurance companies to affiliate within financial holding companies.[245] Under GLBA, financial holding companies may conduct activities that are permitted to bank holding companies and, in addition, may also engage in any activity that is either (i) "financial in nature or incidental to such financial activity," or (ii) "complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[246]

Merchant banking is one of the "financial in nature" activities that are authorized for financial holding companies. GLBA defines merchant banking as the ownership of an interest in a company or other entity that is engaged in one or more activities not otherwise authorized under section 4 of the BHC Act, provided (i) the interest is held "for a period of time to enable the sale or disposition thereof on a reasonable basis," and (ii) the financial holding company "does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition."[247] A broad interpretation of the merchant banking authority granted by GLBA could potentially weaken the separation between banking and commerce, because such an interpretation would allow financial holding companies to maintain long-term control over entities that conduct commercial (i.e., nonfinancial) businesses.[248]

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consolidation within the U.S. banking industry, see, for example, MCCOY, *supra* note 51, § 9.04; Arthur E. Wilmarth, Jr., *Too Good to Be True: The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAN. J.L. BUS. & FIN. 1, 3–5, 9–13 (1995); Wilmarth, *supra* note 212, at 250–54.

[244] Gramm-Leach-Bliley Act (GLBA) § 101, 113 Stat. 1341; *see supra* note 130 and accompanying text (discussing sections 20 and 32 of the Glass-Steagall Act).

[245] *Id.* § 103, 12 U.S.C. § 1843(k)–(o) (2000). For discussions of GLBA's authorization of financial holding companies and its impact in permitting affiliations among banks, securities firms, and insurance companies, see, for example, MCCOY, *supra* note 51, §§ 4.03[1], [3], 5.03[2]; Wilmarth, *supra* note 212, at 219–23, 306–07.

[246] GLBA § 103, 12 U.S.C. § 1843(k)(1) (2000); MCCOY, *supra* note 51, § 5.03[2] (discussing "financial in nature" and "complementary" activities authorized for financial holding companies under GLBA).

[247] GLBA §103, 12 U.S.C. § 1843(k)(4)(H) (2000). GLBA also permits national banks and state banks to establish financial subsidiaries. Financial subsidiaries of banks have fewer powers than nonbank subsidiaries of financial holding companies. Financial subsidiaries of banks may engage only in activities that are "financial in nature or incidental to a financial activity" and may not engage in "complementary" activities. Moreover, financial subsidiaries are expressly barred from (i) underwriting insurance or annuities, (ii) making insurance company portfolio investments, or (iii) engaging in real estate development. Additionally, financial subsidiaries may not engage in merchant banking activities unless the FRB and the Treasury jointly adopt rules permitting that activity. The FRB and the Treasury have not yet adopted such rules. Thus, to date financial subsidiaries have not been allowed to engage in any type of nonfinancial activity. *Id.* §§ 121–22 (codified at 12 U.S.C. §§ 24a, 1831w, 1843 note (2000)); s*ee also* MCCOY, *supra* note 51, § 4.06[1][a].

[248] *See* MCCOY, *supra* note 51, § 4.03[1].

However, the FRB and Treasury have jointly issued regulations that impose strict limitations on merchant banking investments.[249] Those limitations are expressly designed "to help maintain the separation of banking and commerce" and "to ensure . . . that financial holding companies do not use the merchant banking authority as a means of becoming impermissibly involved in nonfinancial activities."[250] Among other things, the regulations (i) prohibit financial holding companies from routinely managing or operating nonfinancial entities in which they have merchant banking investments,[251] (ii) generally establish ten years (or fifteen years, in the case of a private equity fund) as the maximum holding period for a merchant banking investment,[252] and (iii) place aggregate limits on merchant banking investments as a percentage of a financial holding company's capital.[253]

Thus, the FRB and Treasury have so far followed a policy of construing the merchant banking provisions of GLBA in a restrictive manner that is designed to "further the fundamental purposes of the BHC Act—to help maintain the separation of banking and commerce and promote safety and soundness."[254] In addition, because of the special risks posed by equity investments in nonfinancial companies, the FRB has adopted rules that impose significant additional capital charges on financial holding companies that hold merchant banking investments.[255] As a result

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[249] 12 C.F.R. §§ 225.170–225.177 (2006) (FRB rules); *id.* §§ 1500.1–1500.8 (Treasury rules).

[250] Bank Holding Companies and Change in Bank Control, 66 Fed. Reg. 8466, 8468–69 (Jan. 31, 2001) (to be codified at 12 C.F.R. pts. 225 and 1500).

[251] 12 C.F.R. §§ 225.171, 1500.2 (2006); *see* FEIN, *supra* note 127, § 8.03[A].

[252] 12 C.F.R. §§ 225.172, 225.173, 1500.3, 1500.4 (2006); *see* Fein, *supra* note 127, § 8.03[B].

[253] 12 C.F.R. § 225.174 (2006) (generally limiting merchant banking investments to 30% of a financial holding company's Tier 1 capital, or 20% after excluding private equity funds); *id.* § 1500.5; *see also* FEIN, *supra* note 127, § 8.03[C].

[254] Bank Holding Companies and Change in Bank Control, *supra* note 250, at 8466. The joint Treasury/FRB regulations are consistent with statements in GLBA's legislative history affirming that (i) the statutory constraints on merchant banking are "designed to maintain the separation between banking and commerce," H.R. REP. NO. 106-74, pt. 1, at 122 (1999), and (ii) the Treasury and FRB therefore have authority to impose restrictions on merchant banking investments to preserve that separation. *See* 145 CONG. REC. H11529 (daily ed. Nov. 4, 1999) (remarks by Rep. Leach, declaring that the FRB and Treasury have authority to "impose such limitations as they deem appropriate to ensure that this new [merchant banking] authority does not foster conflicts of interest or undermine the safety and soundness of depository institutions or the [BHC] Act's general prohibitions on the mixing of banking and commerce"); 145 CONG. REC. S13788 (daily ed., Nov. 3, 1999) (virtually identical statement by Sen. Sarbanes).

[255] *See* FEIN, *supra* note 127, §§ 7.07[G], 8.05[D]. The FRB's capital charges also apply to the limited equity investments in nonfinancial entities that are permitted by sections 4(c)(6) and (7) of the BHC Act, 12 U.S.C. § 1843(c)(6) & (7) (2000). *See* FEIN, *supra* note 127, § 7.07[G]. Sections 4(c)(6) and (7) allow a bank holding company to own up to 5% of the voting shares of a nonfinancial company or an investment company that invests in the shares of nonfinancial companies. As in the case of merchant banking, the FRB has narrowly construed these exemptions from section 4's general prohibition on nonfinancial activities. For example, the FRB requires that any exempt investments under sections 4(c)(6) and (7) must be completely passive and must not allow the bank holding company to exercise a controlling influence over a nonfinancial company. The FRB's "passivity interpretations" are designed "to keep private economic power unconcentrated, and to put a fault line

of the limitations imposed by the FRB and Treasury, merchant banking investments account for only a tiny fraction of the assets held by financial holding companies.[256]

Similarly, the FRB has included stringent requirements in its orders allowing financial holding companies to engage in activities that the FRB has determined to be "complementary" to financial activities. The FRB has permitted financial holding companies to engage in complementary activity only "on a limited basis" and only if each such activity "is meaningfully connected to a financial activity such that it complements the financial activity."[257] Thus, as in the case of merchant banking, the FRB has taken a "gingerly" approach with regard to complementary activities.[258] The FRB's cautious approach is consistent with the agency's view that GLBA permits a "limited" amount of complementary activities but at the same time, "reject[s] . . . unrestricted affiliations between depository institutions and nonfinancial companies."[259]

For at least three reasons, GLBA's authorization of merchant banking and complementary activities should not be viewed as an abandonment of the congressional policy of separating banking and commerce. First, the FRB has imposed significant limitations on both merchant banking and complementary activities. GLBA gives the FRB a veto power over the scope of merchant banking (as well as other "financial in nature" or "incidental" activities), and GLBA also grants the FRB sole authority to determine the scope of complementary activities.[260] In assigning these gatekeeping roles to the FRB, Congress presumably anticipated that the FRB would perform those roles in a conservative fashion based on the

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between banking and industry." ROE, *supra* note 70, at 98, 190–93; *see also* PAULINE B. HELLER & MELANIE L. FEIN, FEDERAL BANK HOLDING COMPANY LAW §§ 4.03[9], 4.03[10], 6.02, 6.04[1], 6.05[1] (2006); MCCOY, *supra* note 51, § 4.03[2].

[256] Timothy J. Yeager et al., *The Financial Modernization Act: Evolution or Revolution?* 12–13 (Fed. Res. Bank of St. Louis Supervisory Pol'y Analysis, Working Paper No. 2004–05, 2004), *available at* http://ssrn.com/abstract=646261 (reporting that merchant banking investments never exceeded 0.3% of total financial holding company assets during 2000–03).

[257] FRB Order in J.P. Morgan & Co., Nov. 18, 2005, *as reprinted in* 92 FED. RES. BULL. C57, C57 (2006). This FRB order allowed J.P. Morgan to buy and sell physical commodities in the spot market, and to take and make deliveries of physical commodities in order to physically settle commodity derivatives (a previously-approved financial activity). The FRB limited the approved complementary activities to 5% of J.P. Morgan's consolidated Tier 1 capital. *Id.* at C57– C59.

[258] MCCOY, *supra* note 51, § 5.03[2].

[259] FRB Order in Citigroup, Inc., Oct. 2, 2003, *as reprinted in* 89 FED. RES. BULL. 508, 509 (2003). During the debates on GLBA, members of Congress stated that they expected the FRB to impose limitations on complementary activities "that are designed to maintain the separation of banking and commerce" and to ensure that "such activities will not be significant in size." 145 CONG. REC. S13788 (daily ed. Nov. 3, 1999) (remarks of Sen. Sarbanes); *see also* 145 CONG. REC. H11527 (daily ed. Nov. 4, 1999) (remarks of Rep. Leach) (stating that "the American model of separating commerce from banking should be maintained"); *id.* at H11529 (remarks of Rep. Leach) (stating that "[i]t is expected that complementary activities would not be significant relative to the overall financial activities of the organization"); *id.* at H11521 (remarks of Rep. Bentsen).

[260] *See* MCCOY, *supra* note 51, § 5.03[2].

agency's longstanding policy in favor of maintaining a separation between banking and commerce.[261] Second, in adopting GLBA, Congress rejected proposals that would have allowed financial holding companies to own a much larger "basket" of investments in nonfinancial companies.[262]

Third, and most importantly, GLBA did not adopt the 1991 Treasury report's recommendation to allow commercial firms to own financial holding companies. GLBA also closed the unitary SLHC "loophole," which previously allowed commercial firms to acquire FDIC-insured thrifts and to avoid any restrictions on their holding company activities (as long as each commercial firm controlled only one thrift).[263] Applications by commercial firms to establish unitary SLHCs increased significantly after 1996, when Congress passed legislation that recapitalized the deposit insurance fund for thrifts and liberalized QTL criteria for thrifts owned by unitary SLHCs.[264] During 1997–1999, the OTS approved more than eighty

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[261] *See* S. REP. NO. 84-1095 (1956), *as reprinted in* 1956 U.S.C.C.A.N. 2482, 2483 (quoting testimony by FRB chairman William McChesney Martin, Jr., warning of dangers that would result if Congress "permitt[ed] departure from the principle that banking institutions should not engage in business wholly unrelated to banking"); S. REP. NO. 91-1084 (1970), *as reprinted in* 1970 U.S.C.C.A.N. 5519, 5521–22 (quoting similar testimony by FRB chairman Martin); S. REP. NO. 100-19, at 8 (1987), *as reprinted in* 1987 U.S.C.C.A.N. 489, 498 (quoting similar testimony by FRB chairman Paul Volcker); S. REP. NO. 106-44, at 72 (1999) (additional views of Sen. Sarbanes et al.) (quoting similar testimony by FRB chairman Alan Greenspan).

[262] During the House debates on GLBA, Representative Bereuter praised GLBA because it did not give financial holding companies a "commercial market basket" for nonfinancial investments. He explained that he and other members of the House Banking and Financial Services Committee had successfully blocked a proposed amendment that would have permitted a "five percent market basket" for nonfinancial investments. *See* 145 CONG. REC. H11547 (daily ed. Nov. 4, 1999) (remarks of Rep. Bereuter).

In 1997, the same House committee reported a bill that would have allowed all financial holding companies (which the bill called "qualifying bank holding companies") to own banks, securities firms and insurance companies and to generate up to 15% of their domestic gross revenues from nonfinancial activities. H.R. REP. NO. 105-164, pt. 1, at 106 (1997). In contrast, GLBA included a much more limited provision, which applies only to new financial holding companies (i.e., those that were not previously bank holding companies or foreign banks). That provision gives new financial holding companies a limited window period during which they can earn up to 15% of their consolidated gross revenues from nonfinancial activities, but those activities must be discontinued or divested by 2009 (subject to a possible five-year extension with the FRB's approval). *See* MCCOY, *supra* note 51, § 4.03[1] (discussing 12 U.S.C. § 1843(n)).

[263] *See supra* note 234 (discussing regulation of unitary SLHCs).

[264] In 1989, Congress abolished the FSLIC and established within the FDIC two separate deposit insurance funds—the Bank Insurance Fund (BIF) for banks and the Savings Association Insurance Fund (SAIF) for thrifts. Many banks subsequently acquired SAIF-insured deposits by purchasing thrift institutions. In 1996, Congress required all thrifts and all banks holding SAIF-insured deposits to pay a one-time special assessment to recapitalize the SAIF. MCCOY, *supra* note 51, § 11.06[3][a]. The recapitalization of SAIF greatly reduced the cost of future deposit insurance premiums for thrift institutions and maintained the credibility of deposit insurance for thrifts. In addition, Congress liberalized the QTL by expanding the amounts of commercial and consumer loans that would qualify for QTL treatment. Both measures made the thrift charter much more attractive, especially for nonbanking companies that were barred from acquiring banks under the BHC Act. *See* Edward J. Kane, *Implications of Superhero Metaphors for the Issue of Banking Powers*, 23 J. BANKING & FIN. 663, 666–67 (1999); Ira L. Tannenbaum, *Federal Thrift Charter Popularity Continues*, 18 BANKING POL'Y REP. No. 3, Feb. 1, 1999, at 1, 17. In 2006, Congress adopted legislation merging the BIF and

applications for unitary SLHCs. Most of the applicants were securities firms or insurance companies, but a significant number were retailers and other commercial firms.[265] At the end of October 1999, more than fifty additional applications for unitary SLHCs were pending before the OTS. The pending applications included Wal-Mart's proposal (filed on June 29, 1999) to acquire a federal savings association in Oklahoma.[266]

Wal-Mart's proposal, which would have given Wal-Mart "the flexibility to be able to offer a full array of financial services,"[267] mobilized political support for congressional efforts to prohibit further acquisitions of thrifts by commercial firms.[268] Consequently, GLBA included a provision that bars any company from acquiring a savings association unless the acquiring company and all of its subsidiaries are engaged in activities permissible either for financial holding companies or for multiple SLHCs. Like financial holding companies, multiple SLHCs must generally limit their operations to financial activities. GLBA exempted unitary SLHCs from the prohibition on commercial ownership if (i) they were already in existence on May 4, 1999, or (ii) applications to establish them were filed by that date with the OTS. However, GLBA prohibited commercial firms from purchasing any of the grandfathered unitary SLHCs, thereby barring Wal-Mart from acquiring control of any thrift.[269] At the end of 2004, only seventeen commercially-owned unitary SLHCs remained in existence.[270]

During the Senate and House debates on GLBA, members of Congress and the Clinton Administration declared that closing the unitary SLHC "loophole" was essential to maintain the separation between banking and commerce.[271] In view of GLBA's limitations on the activities of financial holding companies and GLBA's closing of the unitary SLHC loophole, the

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the SAIF into a unified Deposit Insurance Fund administered by the FDIC. MCCOY, *supra* note 51, § 11.06[3][b].

[265] *See* Tannenbaum, *supra* note 264, at 1, 15–16; Alan Kline, *Community Bankers Hail the Defeat of Unitary Thrifts—and Wal-Mart*, AM. BANKER, Oct. 26, 1999, at 1, *available at* LEXIS, News Library AMBNKR File.

[266] Kline, *supra* note 265.

[267] *Wal-Mart Applies for Thrift Charter with OTS*, NAT'L MORTGAGE NEWS, July 5, 1999, at 16 (quoting Wal-Mart spokesman Jay Allen).

[268] Kline, *supra* note 265. During the House debates on the conference report for GLBA, Representative Baker made clear that Wal-Mart was a specific target of Congress's decision to close the unitary SLHC "loophole." *See* 145 CONG. REC. H11524 (daily ed. Nov. 4, 1999) (statement of Rep. Baker).

[269] *See* Gramm-Leach-Bliley Act § 401 (codified at 12 U.S.C. § 1467a(c)(9) (2000)); *see* MCCOY, *supra* note 51, § 4.04 (discussing GLBA's impact on unitary SLHCs and also explaining the restrictions on activities of multiple SLHCs).

[270] GAO-ILC REPORT, *supra* note 39, at 68.

[271] *See* 145 CONG. REC. S13788 (daily ed. Nov. 3, 1999) (statement of Sen. Sarbanes); *see also* 145 CONG. REC. S13875 (daily ed. Nov. 4, 1999) (statement of Sen. Johnson); *id.* at S13904 (statement of Sen. Kerry); *id.* at S13915 (reprinting letter from Treasury Secretary Lawrence H. Summers); *id.* at S13916 (statement of Sen. Daschle); *id.* at H11516 (statement of Rep. Roukema); *id.* at H11528 (statement of Rep. Leach).

statute should be viewed as a reaffirmation of Congress's policy in favor of maintaining a division between the two fields of activity.[272]

5. *Summarizing the History of Legal Restrictions on Bank Powers and Affiliations, 1787–1999*

Since the nation's founding, banks have frequently tried to expand their activities into commercial fields, and commercial firms have often attempted to gain control of banks. In response to those efforts, federal and state legislators have repeatedly passed laws to separate banks from commercial enterprises. Legislators have imposed legal limitations on bank powers and affiliations whenever it became evident that either (i) the involvement of banks in commerce was threatening their safety and soundness, or (ii) commercial firms were acquiring control of large numbers of banks.

The limited charters granted by the Pennsylvania legislature to the Bank of North America in 1787, and by Congress to the First and Second Banks of the United States in 1791 and 1816, show that legislators were concerned about separating banking from commerce during the Republic's earliest years.[273] State legislatures adopted "free banking" statutes during the mid-19th century that prohibited banks from engaging in commercial activities, and Congress followed the same approach in the National Bank Act of 1864. Those statutory constraints reflected a legislative revulsion against the severe economic crisis of the early 1840s, which was precipitated by the collapse of the Bank of the United States of Philadelphia and Morris Canal and Banking Company following their aggressive expansion into commercial activities.[274]

The failures of large financial-commercial conglomerates during 1930–1933—including Caldwell and Company, Bank of United States and the two largest Detroit banks—helped to produce the Glass-Steagall Act, which imposed significant restrictions on the activities and affiliations of banks.[275] Similarly, the thrift debacle of the 1980s—including the failures of Lincoln Savings and other institutions that were heavily involved in real estate development and other commercial activities—led to FIRREA.[276] Among other things, FIRREA prohibited state-chartered thrifts from engaging as principal or investing in commercial enterprises that were not permissible for federal savings associations.[277] After a wave of bank

[272] *See* GAO-ILC REPORT, *supra* note 39, at 15 (concluding that "GLBA generally reaffirmed the separation of banking from nonfinancial, commercial industries").

[273] *See supra* notes 71–73 and accompanying text.

[274] *See supra* notes 74–75, 91–94 and accompanying text.

[275] *See supra* Part III.A.2.

[276] *See supra* Part III.A.4.a.

[277] *See supra* note 231 and accompanying text.

failures in the late 1980s, Congress imposed comparable limitations on the powers of state-chartered banks in 1991.[278]

On four occasions since 1950, Congress has enacted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. When Transamerica and other commercial firms purchased numerous banks during the 1950s, Congress responded in 1956 by adopting the BHC Act, which prohibited multibank holding companies from engaging in activities that were not "closely related to banking."[279] When commercial conglomerates established a large number of one-bank holding companies in the late 1960s, Congress responded in 1970 by extending the BHC Act to reach those holding companies.[280] In 1987, after commercial firms purchased dozens of FDIC-insured nonbank banks, Congress stopped further purchases by adopting CEBA.[281] In 1999, after commercial firms acquired a substantial number of FDIC-insured thrift institutions, Congress barred further acquisitions by enacting GLBA.[282] On all four occasions, Congress declared that it acted in order to maintain a separation between banking and commerce.

Thus, the policy of separating banking and commerce has gained strength over time and has operated with particular force since 1956. It is true that the FRB could undermine that policy by adopting expansive interpretations of GLBA's provisions allowing financial holding companies to engage in merchant banking or other activities that are "financial in nature" or "incidental" or "complementary" to such activities. However, given the FRB's longstanding policy position against mixing banking and commerce, it seems very unlikely that the FRB will allow a broad range of commercial activities under GLBA within the foreseeable future.[283]

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[278] *See supra* notes 239–41 and accompanying text.

[279] *See supra* Part III.A.3.a.

[280] *See supra* Part III.A.3.b.

[281] *See supra* Part III.A.3.c.

[282] *See supra* notes 263–69 and accompanying text.

[283] *See supra* notes 248–61 and accompanying text. In 2006, the FRB opposed legislative proposals that would have allowed ILCs to offer NOW accounts to for-profit businesses and to establish interstate de novo branches. The FRB noted that "any type of company may acquire an FDIC-insured ILC . . . without regard to the activity restrictions that Congress has established to maintain the general separation of banking and commerce." *Statement of Donald L. Kohn, Member, Board of Governors of the Federal Reserve System: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. 15 (Mar. 1, 2006), *available at* http://www.federalreserve.gov/boarddocs/testimony/2006/20060301/default.htm. The FRB therefore argued that the proposals for expanded ILC powers had "the potential to undermine" Congress' policy of separating banking and commerce. *Id.* at 14. Congress did not include any provisions dealing with ILCs when it subsequently enacted regulatory relief legislation. *See* Kini & Bondehagen, *supra* note 52, at 5.

B. *Do Commercially-Owned ILCs Pose Significant Risks to the U.S. Financial System and General Economy?*

For at least three reasons, continued acquisitions of ILCs by commercial firms are likely to create serious risks for our nation's financial system and general economy. First, the ownership of ILCs by large commercial firms is likely to spread federal safety net subsidies—including "too big to fail" (TBTF) bailouts—from the financial sector to the commercial sector of the economy. The ability of commercial owners of ILCs to gain access to low-cost, FDIC-insured funds will increase the risks to the deposit insurance fund and will create competitive inequities between commercial firms that control ILCs and those that do not.

Second, commercially-owned ILCs are subject to conflicts of interest that encourage them to make loans and investments to benefit their commercial affiliates. As shown by the financial history of the United States and other nations, preferential transfers of funds from banks to commercial affiliates or their customers create significant risks for the deposit insurance fund and also increase the likelihood of a systemic economic crisis. Additionally, such transfers provide commercial owners of ILCs with an unfair competitive advantage over firms that do not have bank affiliates.

Third, problems arising at commercial owners of ILCs are likely to create public concerns about the soundness of the ILCs. Commercially-owned ILCs will, therefore, be subject to contagious losses of confidence, producing a greater likelihood of TBTF bailouts by federal authorities. The potential extension of TBTF protection to commercial owners of ILCs is likely to produce a more intrusive government role in regulation of the commercial sector.

1. *Expansion of the Federal Safety Net and TBTF Subsidies to Commercial Owners of ILCs*

During the 1990s, scholars, regulators and lawyers debated whether the federal "safety net" for financial institutions provided a net subsidy to banks.[284] Those who denied the existence of a net subsidy argued that the costs of banking regulation exceeded the value of any safety net subsidy.[285]

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[284] The federal "safety net" for financial institutions consists of (i) federal deposit insurance, (ii) protection for uninsured depositors and other uninsured creditors of TBTF institutions, (iii) discount window advances provided by the FRB as "lender of last resort" (LOLR), and (iv) the FRB's guarantee of interbank payments made on Fedwire. *See* Joe Peek & James A. Wilcox, *The Fall and Rise of Banking Safety Net Subsidies*, *in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 169, 179–83 (Benton E. Gup ed., 2004); John R. Walter, *Can a Safety Net Subsidy Be Contained?*, 84 FED. RES. BANK OF RICH. ECON. REV. Quarter 1 1998, at 1, 2; Wilmarth, *supra* note 212, at 447 n.1033.

[285] For helpful overviews of this debate, see MCCOY, *supra* note 51, § 4.02, and Peek & Wilcox, *supra* note 284, at 184–86.

However, a more recent study concluded that safety net subsidies have increased since the mid-1990s and probably do provide a net subsidy to most banks.[286] Similarly, a 2005 GAO report stated that the federal safety net "provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds," and by "shift[ing] part of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers."[287]

During a systemic crisis, the safety net subsidy is likely to become very large because the federal government, in effect, provides "catastrophe insurance."[288] If the deposit insurance fund is inadequate to cover the cost of resolving failed banks, the federal government has shown a willingness to mobilize taxpayer funds to prevent a collapse of the financial system.[289] For example, during the thrift and banking crises of 1980–1994, the deposit insurance funds for banks and thrifts spent $64 billion in resolving the failures of nearly 3000 thrifts and banks. The thrift deposit insurance fund was wiped out, and Congress used $132 billion of taxpayer funds to cover the full cost of resolving thrift failures. The bank deposit insurance fund was depleted to the point of insolvency, and Congress expanded the FDIC's line of credit at the Treasury from $5 billion to $30 billion.[290] Many other nations have similarly provided extensive liquidity assistance to banks and generous protection to bank depositors during systemic financial crises in the 1980s and 1990s.[291] Thus, the subsidy provided by the federal safety net increases greatly in magnitude during a financial crisis.

Whether or not small banks enjoy a subsidy, many analysts believe that the safety net provides significant subsidies to the largest banks that are viewed as TBTF by the financial markets. Those analysts have found that (i) TBTF banks—generally those with assets over $100 billion—pay interest rates on deposits that are significantly lower than the rates paid by non-bank companies of comparable size on short-term, uninsured debt, (ii) TBTF banks operate with significantly higher leverage (i.e., lower capital-to-asset ratios) than uninsured financial intermediaries such as commercial and consumer finance companies and life insurers, and (iii) TBTF banks

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[286] Peek & Wilcox, *supra* note 284, at 170, 187–89.

[287] GAO-ILC REPORT, *supra* note 39, at 71–72.

[288] Peek & Wilcox, *supra* note 284, at 180.

[289] *Id.* at 180–81.

[290] Wilmarth, *supra* note 212, at 448. Resolving the failures of 1300 thrifts cost a total of approximately $160 billion, of which $28 billion was provided by FSLIC funds and $132 billion was covered by taxpayer funds. *Id.* at 355 n.590. Resolving the failures of 1600 banks cost $36 billion, all of which was taken from the FDIC's bank insurance fund. That fund effectively became insolvent in 1991. At that point, Congress provided the FDIC with authority to borrow up to $30 billion from the Treasury (an authority that the FDIC ultimately did not have to use). *Id.* at 313–14 & n.397.

[291] *See* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 40, 75–77 (2004); Wilmarth, *supra* note 212, at 308–12; *infra* Part III.B.2.b (discussing governmental responses to financial crises in Japan, South Korea and Mexico during the 1990s).

achieve higher credit ratings and pay lower interest rates on their bonds as they grow in size to achieve TBTF status.[292] Indeed, the TBTF subsidy has been an important motivating factor behind the rapid consolidation that has taken place in the banking industry in the United States and other developed nations over the past two decades.[293]

The existence of a subsidy for TBTF institutions is further indicated by the fact that no major U.S. bank has ever surrendered its bank charter and chosen to operate as a nonbank.[294] In contrast, large nonbanking companies have consistently sought to gain control of FDIC-insured depository institutions. As discussed above, securities firms, life insurance companies and commercial firms acquired nonbank banks before the nonbank bank loophole was closed in 1987, and they also acquired thrifts before the unitary SLHC loophole was closed in 1999.[295] Each of the four largest U.S. securities firms—Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers—owns a Utah-chartered ILC.[296] Charles Schwab, the largest discount securities broker, and MetLife, the largest life insurer, purchased banks shortly after the enactment of GLBA and became financial holding companies.[297] Currently, thirty-three insurance companies own some type of bank,[298] and fifteen commercial firms own ILCs.[299] If the costs of bank regulation actually exceed the benefits provided by the federal safety net, it is very difficult to understand why no major bank has ever given up its charter, and why so many nonbanking

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[292] *See, e.g.*, STERN & FELDMAN, *supra* note 291, at 30–37; Edward J. Kane, *Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?*, 32 J. MONEY, CREDIT & BANKING 671, 673, 691–94 (2000); Maria Fabiana Penas & Haluk Unal, *Gains in Bank Mergers: Evidence from the Bond Markets*, 74 J. FIN. ECON. 149, 150–51, 155, 159, 168–71 (2004); George Pennacchi, *Deposit Insurance, Bank Regulation, and Financial System Risks*, 53 J. MONETARY ECON. 1, 14–16 (2006); Wilmarth, *supra* note 212, at 301–03, 445, 447 n.1033; Donald P. Morgan & Kevin J. Stiroh, *Bond Market Discipline of Banks: Is the Market Tough Enough?* 2–3, 13–15 (Fed. Reserve Bank N.Y. Staff Report, Working Paper No. 95, 1999), *available at* http://papers.ssrn.com/abstract=207148 [*hereinafter* Morgan & Stiroh, *Bond Market*]; Donald P. Morgan & Kevin J. Stiroh, *Too Big to Fail After All These Years, passim* (Fed. Reserve Bank N.Y. Staff Report, Working Paper No. 220, 2005), *available at* http://ssrn.com/abstract=813967 [*hereinafter* Morgan & Stiroh, *Too Big to Fail*].

[293] *See, e.g.*, STERN & FELDMAN, *supra* note 291, at 32–33, 60–79; Gerald A. Hanweck & Bernard Shull, *The Bank Merger Movement: Efficiency, Stability and Competitive Policy Concerns*, 44 ANTITRUST BULL. 251, 251, 273–79 (1999); Kane, *supra* note 292, at 673–74, 683–95; Wilmarth, *supra* note 212, at 300–12. For recent surveys describing the rapid consolidation occurring within the banking and financial services industries in the United States and many other developed nations, see Kenneth D. Jones & Chau Nguyen, *Increased Concentration in Banking: Megabanks and Their Implications for Deposit Insurance,* 14 FIN. MARKETS, INST. & INSTRUMENTS 1 (2005); Gianni de Nicolo et al., *Bank Consolidation, Internationalization, and Conglomeration: Trends and Implications for Financial Risk*, 13 FIN. MARKETS, INST. & INSTRUMENTS 173 (2004).

[294] Wilmarth, *supra* note 212, at 447 n.1033.

[295] *See id.* at 423–24; *see also supra* notes 165, 264–66 and accompanying text.

[296] Statement of Douglas H. Jones, *supra* note 42, at Attachment 1.

[297] Wilmarth, *supra* note 212, at 223.

[298] *See* Clint Riley, *Insurers Win Customers, Profits With Banking*, WALL ST. J., Oct. 2, 2006, at C1, *available at* LEXIS, News Library, WSJNL File.

[299] FDIC Moratorium Extension Notice, *supra* note 13, at 5291.

companies have been so eager for so long to acquire a financial institution charter that will enable them to offer FDIC-insured deposits to their customers. In my view, banks and nonbanking companies have indisputably proven the existence of a safety net subsidy—at least for large financial institutions—by voting with their feet.

Merrill Lynch is a leading example of a non-bank financial institution that has reaped significant benefits from its access to the federal safety net. Merrill acquired a thrift institution and an ILC during the 1990s.[300] In 2000, Merrill introduced a "sweep account" program in order to transfer its customers' cash balances from uninsured brokerage accounts into FDIC-insured deposits in its subsidiary depository institutions.[301] By 2006, Merrill's banks held $80 billion in deposits, and Merrill used those deposits to fund $70 billion of commercial and consumer loans.[302] Citigroup's Smith Barney brokerage unit and other major securities brokers have introduced similar sweep account programs to move customer cash balances into FDIC-insured deposits at their affiliated banks.[303]

A 2004 study estimated that sweep account programs created $350 billion of FDIC-insured deposits that otherwise would have been held in uninsured money market mutual funds (MMMFs) at brokerage firms.[304] Securities firms with bank affiliates have established these programs because FDIC-insured deposits pay interest rates that are much lower, and earn spreads that are much higher, than the rates and spreads applicable to uninsured MMMFs.[305] A recent comment letter submitted to the FDIC by

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[300] *Banking in Utah: From Mormon to mammon*, ECONOMIST, June 9, 2001, at 74, 75, *available at* LEXIS, News Library, ECON File; Katherine Fraser, *Merrill Lynch Using Thrift Charter To Build Its Personal Trust Business*, AM. BANKER, Aug. 10, 1998, at 1, *available at* LEXIS, News Library, AMBNKR File.

[301] Pennacchi, *supra* note 292, at 15; Wilmarth, *supra* note 212, at 424–25.

[302] Matt Ackermann, *Merrill Eyes Organic Growth But May Do a Banking Deal*, AM. BANKER, April 19, 2006, at 9, *available at* LEXIS, News Library, AMBNKR File (reporting on Merrill's bank deposits and loans); *see also* Matthias Rieker, *Merrill's Retail Banking Strategy Seen Paying Off*, AM. BANKER, June 12, 2003, at 20, *available at* LEXIS, News Library, AMBNKR File (reporting that Merrill's funding from bank deposits grew from 14% to 51% during 1998–2003, while its funding from short-term borrowing declined from 21% to 2%). In January 2007, Merrill further increased its banking assets by agreeing to purchase a California bank, First Republic. Andrew Dowell & David Enrich, *Merrill Buys First Republic to Beef Up Banking Services*, WALL ST. J., Jan. 30, 2007, at C5, *available at* LEXIS, News File, WSJNL File.

[303] Pennacchi, *supra* note 292, at 15 n.21; Wilmarth, *supra* note 212, at 424–25, 448–49.

[304] Pennacchi, *supra* note 292, at 15 (citing study by Crane and Krasner).

[305] *Id.* at 15–16; Wilmarth, *supra* note 212, at 448; Randall Smith, *How Wall Street 'Sweeps' the Cash*, WALL ST. J., Jan. 11, 2007, at C1, *available at* LEXIS, News File, WSJNL File. Unlike bank deposits, which can be used to fund commercial and consumer loans, MMMFs may only invest in highly-rated securities with an average maturity of not more than ninety days. Timothy Q. Cook & Jeremy G. Duffield, *Money Market Mutual Funds and Other Short-Term Investment Pools*, *in* INSTRUMENTS OF THE MONEY MARKET 156, 165–67 (Timothy Q. Cook & Robert K. Laroche eds., 7th ed. 1993), *available at* http://www.richmondfed.org/publications/economic_research/instruments_of_the_money_market/.

the Securities Industry Association (SIA) confirms the significant benefits produced by sweep programs:

> Bank subsidiaries have added significant value and versatility to SIA member corporate groups, because SIA member owned banks hold idle funds swept from brokerage accounts [into] deposits. . . . This has provided a reliable and low cost source of deposits to fund traditional banking products and services offered to customers of the corporate group . . . . The most cost effective way to fund bank quality loans is with deposits.[306]

In addition to the subsidy offered by access to FDIC-insured deposits, many commentators believe that GLBA has enabled large financial conglomerates that control banks to secure presumptive TBTF status.[307] Owners of major commercial firms might reasonably expect that they, too, will receive TBTF treatment if they acquire ILCs and expand the assets of their ILCs as rapidly as Merrill has done.[308] If Wal-Mart, the world's largest retailer, and Home Depot, the second largest U.S. retailer, are allowed to open deposit-taking branches in their stores, they would probably match or improve on Merrill's deposit-taking performance.[309]

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

[307] HENRY KAUFMAN, ON MONEY AND MARKETS: A WALL STREET MEMOIR 209–10, 237–40 (2000); STERN & FELDMAN, *supra* note 291, at 70–77; Wilmarth, *supra* note 212, at 303-04, 446-50, 474-75. During the debates on the conference report on GLBA, several members of Congress warned that GLBA had not solved the TBTF problem and that the TBTF doctrine might therefore be extended to financial conglomerates. *See* 145 CONG. REC. S13888 (daily ed., Nov. 4, 1999) (statement of Sen. Reed); *id.* at S13896–97 (statement of Sen. Dorgan); *id.* at S13904 (remarks of Sen. Kerry); *id.* at H11542 (1999) (statement of Rep. Dingell); 145 CONG. REC. S13789 (daily ed. Nov. 3, 1999) (statement of Sen. Sarbanes). In 2000, a senior official at Moody's Investor Services argued that federal regulators must support all components of big financial conglomerates during "times of extreme financial stress." In his view, the TBTF status of major financial holding companies is undeniable, because it is "like the elephant at the picnic—everyone is aware of it, but no one wants to mention it." Christopher T. Mahoney, Commentary, FRBNY ECON. POL'Y REV., Oct. 2000, at 55, 57, *available at* http://www.newyorkfed.org/research/epr/2000n4.html.

[308] In fact, the FRB has authority to extend discount window loans to any non-banking company "in unusual and exigent circumstances." 12 U.S.C. § 343 (2000). Section 343 would permit the FRB to provide financial support to any non-banking firm whose survival is deemed necessary to maintain the stability of the financial markets. *See* Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 873–74 (2000); Wilmarth, *supra* note 212, at 304 & n.369.

[309] Wal-Mart operates some 3300 stores in the United States and about 6700 stores globally. Kris Hudson, *Wal-Mart Blames Short-Term Woes, But Some Expect Challenges to Linger*, WALL ST. J., Dec. 28, 2006, at C1, *available at* LEXIS, News Library, WSJNL File. During its 2006 fiscal year, Wal-Mart produced total sales of $349 billion, making it the largest retailer in the United States and the world. James Covert, *Earnings Digest—Retail: Wal-Mart Pegs Growth on Overseas Arm*, WALL ST. J., Feb. 21, 2007, at C6, *available at* LEXIS, News Library, WSJNL File. Home Depot operates more than 2100 stores in the United States and generated total sales of $91 billion in 2006, making it the

Given the immense size of both Wal-Mart and Home Depot, it seems inconceivable that federal regulators would allow either company to collapse, if the company owned a major financial institution. Wal-Mart, for example, generates annual domestic sales of about $300 billion and accounts for 8% of domestic retail sales and 2% of the gross domestic product.[310] On several occasions since 1970, the federal government has intervened to save or reorganize a company or industry whose survival was deemed important to the national interest.[311] On at least four other occasions since 1970, the FRB has taken action to maintain the stability of the financial markets after the failure of a major non-banking firm.[312] Given those precedents, acquisitions of ILCs by Wal-Mart, Home Depot and other giant commercial firms will significantly increase the likelihood and potential costs of similar federal interventions in the future.

Based on the foregoing considerations, it seems clear that (i) large commercial owners of ILCs will obtain substantial financial benefits from the federal safety net, particularly in the form of low-cost deposits and implicit catastrophe insurance, and (ii) those commercial firms will have a significant funding advantage—and therefore an important competitive edge—over competitors that do not own ILCs.[313] Unless acquisitions of ILCs by commercial firms are prohibited, many large commercial entities will probably deem it essential to acquire ILCs in order to maintain competitive parity with those firms that already own ILCs. Thus, over time, acquisitions of ILCs by large commercial firms will almost certainly create serious distortions within the general economy.

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second largest U.S. retailer. Ann Zimmerman, *Home Depot Tries to Make Nice to Customers*, WALL ST. J., Feb. 20, 2007, at D1, *available at* LEXIS, News Library, WSJNL File; Ann Zimmerman & Mary Ellen Lloyd, *Nardelli's Flawed Strategy Hits Home Depot Profit*, WALL ST. J., Feb. 21, 2007, at A2, *available at* LEXIS, News Library, WSJNL File.

[310] *See* Kris Hudson, *Wal-Mart Scales Back Expansion, Spending as Sales Growth Slows*, WALL ST. J., Oct. 24, 2006, at A1, *available at* LEXIS, News Library, WSJNL File; *Special Report Wal-Mart: How big can it grow?*, ECONOMIST, Apr. 17, 2004, at 67, *available at* LEXIS, News Library, ECON File.

[311] *See* Benton E. Gup, *What Does Too Big to Fail Mean?*, *in* TOO BIG TO FAIL, *supra* note 284, at 29, 33–38 (discussing (i) federal support for the reorganization of railroads following Penn Central's bankruptcy in 1970, (ii) federal loan guarantees given to Lockheed in 1971 and Chrysler in 1980, and (iii) federal payments and loan guarantees provided to airlines after the terrorist attacks on September 11, 2001).

[312] *See id.* at 33, 41 (discussing FRB's interventions following the collapse of Penn Central in 1970 and Long Term Capital Management (LTCM) in 1998); KAUFMAN, *supra* note 307, at 208, 255–58, 272–73, 282–84 (discussing the same two episodes as well as the FRB's interventions following the Hunt brothers' failed attempt to corner the silver market in 1980 and the stock market crash of 1987); Wilmarth, *supra* note 212, at 236, 346–48, 370–72, 451, 472–73 (discussing the same four episodes).

[313] *See* GAO-ILC REPORT, *supra* note 39, at 71–72.

2. *Conflicts of Interest, Preferential Lending and Systemic Risk*

a. Evidence from the United States

Acquisitions of ILCs by commercial firms create conflicts of interest that pose significant risks to the deposit insurance fund and increase the likelihood of a systemic economic crisis. As shown above, ILCs enjoy a significant funding advantage over non-banking firms, due to their ability to attract FDIC-insured deposits at subsidized, below-market rates.[314] Commercial owners of ILCs have powerful financial incentives to transfer this funding advantage by causing their ILCs to pay generous dividends and to make preferential loans to the parent companies and their commercial subsidiaries. The desire to draw on funds from a bank affiliate intensifies when the commercial parent or a commercial affiliate encounters financial problems. For example, after Caldwell and Company and American Continental Company (the parent of Lincoln Savings) lost access to other sources of funds, they extracted large amounts of funds from their depository institution affiliates.[315] Similarly, Bank of United States failed after making large loans to support its securities and real estate affiliates.[316]

Commercial firms could also cause their ILCs to support their operations in other ways. For example, a parent company could cause its ILC to purchase doubtful customer receivables or other questionable assets, or it could insist that the ILC encourage its depositors and other customers to purchase the parent's securities. As discussed above, American Continental used the branches and employees of Lincoln Savings to promote the sale of American's uninsured subordinated notes to more than twenty thousand of customers.[317] Bank of United States similarly persuaded thousands of its depositors to buy units consisting of the bank's stock joined with the stock of its primary securities affiliate.[318] Likewise, in the early 1970s Beverly Hills Bancorp sold $12.5 million of commercial paper to more than two hundred customers of its subsidiary bank, Beverly Hills National Bank. After the parent company defaulted on

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[314] *Id.*; *see also supra* notes 292, 300–06 and accompanying text.

[315] *See supra* notes 108, 217–23 and accompanying text. Similarly, "when Drexel Burnham was threatened with failure in early 1990, it [made capital withdrawals] from its regulated securities subsidiaries in excess of regulatory limits until the SEC intervened to prevent further capital transfers." Wilmarth, *supra* note 212, at 456 n.1058; *see also* JONATHAN BROWN, THE SEPARATION OF BANKING AND COMMERCE 25, *available at* http://www.public-gis.org/reports/sbc.html (quoting SEC chairman Richard Breeden's Senate testimony concerning Drexel Burnham's failure, in which Mr. Breeden acknowledged that the SEC did not fully appreciate the "risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors").

[316] *See supra* notes 116–17 and accompanying text.

[317] *See supra* note 224 and accompanying text.

[318] *See supra* note 116 and accompanying text.

the commercial paper, the customers sued the bank and forced it into conservatorship and liquidation.[319]

In addition, commercial firms may induce their ILCs to make preferential loans to suppliers of the parent company in order to gain concessions for the parent company.[320] Commercial firms can similarly use their ILCs to extend credit to customers to promote the sale of the parent's products.[321] For example, Volkswagen, Target, and Toyota acquired ILCs during 2002–2004.[322] The primary business of both Volkswagen Bank and Toyota Financial Savings Bank is to make loans to consumers and businesses to finance purchases of automobiles produced by their parent companies. Similarly, Target Bank issues proprietary credit cards to business firms to facilitate their purchases of goods at Target stores.[323] Home Depot has filed an application to acquire a Utah ILC called EnerBank. EnerBank's proposed business plan is to make installment loans to consumers who hire EnerBank-approved contractors for home improvement projects. Home Depot hopes that EnerBank's loans will encourage approved contractors to purchase materials for home improvement projects at Home Depot stores. Although Home Depot claims that contractors will not be compelled to buy their materials at Home Depot stores, contractors cannot participate in the program unless they are approved by EnerBank as "loan program sponsors."[324] It certainly seems doubtful whether a contractor would retain its status as an approved

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[319] *In re* Beverly Hills Bancorp, 649 F.2d 1329, 1331–33 (9th Cir. 1981); *see also infra* notes 385–87 and accompanying text (discussing the parent company's default and the bank's liquidation).

[320] *See* BROWN, *supra* note 315 (stating that, prior to the enactment of the 1970 amendments to the BHC Act, federal examiners discovered that a commercial bank controlled by Sears "had a heavy concentration of its commercial loans to firms that were Sears' suppliers"); *see also* GAO-ILC REPORT, *supra* note 39, at 72.

[321] BROWN, *supra* note 315, at 5-6, 12–13; *see also* GAO-ILC REPORT, *supra* note 39, at 72.

[322] *See* Statement of Douglas H. Jones, *supra* note 42, at Attachment 1.

[323] *Id.* A recent comment letter submitted to the FDIC by two ILC trade associations explained how an ILC can provide credit to customers of its parent company in compliance with sections 23A and 23B. The comment letter stated that an ILC can lawfully make loans to its parent's customers as long as the parent either (i) buys the customer loans from the ILC without recourse, or (ii) maintains a cash deposit at the ILC equal to the amount of outstanding customer loans. *See* Letter to the FDIC, , from the Utah Association of Financial Services/California Association of Industrial Banks (Oct. 10, 2006),, *in* Comments to the FDIC on ILCs, *supra* note 306, at Comment No. 109, 12, 33-34. If the letter is correct, a commercial parent company can call upon its ILC to provide unlimited credit to the parent's customers as long as the parent company is willing to cover the credit risk associated with those loans. However, that arrangement provides relatively little comfort to the federal deposit insurance fund and taxpayers, because excessive and unsound loans to customers could inflict crippling losses on the parent company. As discussed below, problems at parent companies of financial institutions have frequently proven to be contagious by undermining public confidence in the subsidiary institutions. *See infra* Part III.B.3.

[324] *See* Home Depot, Inc., Change in Bank Control Notice: Public Portion of Notice, May 8, *available at* 2006, http://www.fdic.gov/regulations/laws/homedepot (last visited Apr. 8, 2007); Luke Mullins, *Home Depot's ILC-to-Be—A Look Inside*, AM. BANKER, July 28, 2006, at 1, *available at* LEXIS, News Library, AMBNKR File.

EnerBank "sponsor" if it failed to buy a significant portion of its materials from Home Depot.

Thus, the existing and proposed business plans of commercially-owned ILCs reflect a consistent strategy among commercial parent companies to promote the sale of their products by using the credit facilities of their captive ILCs. Advocates for commercial ownership of ILCs argue that "firewalls" established by laws restricting affiliate transactions and insider lending will prevent an ILC from making unsound loans or abusive transfers of funds to benefit its commercial affiliates.[325] As previously discussed, sections 23A and 23B of the Federal Reserve Act impose quantitative limits and collateral requirements on affiliate transactions, prohibit bank purchases of low-quality assets from affiliates, and require affiliate transactions to be conducted on arms' length terms.[326] In addition, federal statutes and regulations impose strict conditions on loans made by any FDIC-insured banks to directors, executive officers and principal shareholders and their related interests.[327]

However, these firewalls have often been disregarded under circumstances of financial stress when the financial viability of a controlling shareholder or affiliate is threatened. As noted above, a high percentage of thrift failures during the 1980s involved violations of rules governing affiliate transactions and insider lending.[328] Similarly, a GAO study found that unlawful insider lending and abusive affiliate transactions occurred at a significant proportion of 175 banks that failed during 1990–1991.[329] For example, United States National Bank of San Diego failed in 1973 after making massive loans to its controlling shareholder and his affiliates in violation of legal lending limits.[330] Hamilton National Bank also failed in 1976 after its parent holding company violated section 23A by forcing the bank to purchase large amounts of low-quality mortgages from the bank's mortgage banking affiliate.[331] During the 1987 stock

[325] *See, e.g.*, Blair, *supra* note 52, at 98–99, 103–04; Lawrence J. White, *Testimony bfere Federal Deposit Insurance Corporation*, *in* Wal-Mart Hearings, *supra* note 12, at 4–11 (Panel 3, Apr. 11, 2006).

[326] *See supra* notes 131, 176–77 and accompanying text (discussing sections 23A and 23B).

[327] *See* MCCOY, *supra* note 51, § 14.04[1][d] (discussing restrictions on loans to insiders under 12 U.S.C. §§ 375a, 375b, 1468(b) and 1828(j)(2) and the regulations adopted thereunder).

[328] *See supra* notes 207, 217–23 and accompanying text.

[329] Catharine M. Lemieux, *Conglomerates, Connected Lending and Prudential Standards: Lessons Learned*, 4 UCLA J. INT'L L. & FOREIGN AFF. 149, 157–58 (1999) (stating that the GAO study found violations of insider lending rules at eighty-two of the 175 failed banks and also found preferential insider loans at seventy banks and improper affiliate transactions at forty-nine banks).

[330] *See* JOSEPH F. SINKEY, JR., PROBLEM AND FAILED INSTITUTIONS IN THE COMMERCIAL BANKING INDUSTRY 218–33 (1979); *see also* First Empire Bank v. FDIC, 572 F.2d 1361, 1364–65 (9th Cir. 1978); Harmsen v. Smith, 542 F.2d 496, 502 (9th Cir. 1976).

[331] SINKEY, *supra* note 330, at 198–205.

market crash, Continental Illinois violated legal lending limits in order to prevent its options trading subsidiary from failing.[332]

Two large FDIC-insured ILCs have failed since 1999, resulting in losses to the deposit insurance fund of more than $100 million.[333] In each case, the corporate parent and the ILC operated in a unitary fashion that did not maintain any meaningful corporate separation between them, and the parent and the ILC also engaged in transactions that violated sections 23A and 23B.[334] While the violations of sections 23A and 23B were not the primary reason for the ILCs' failures, those violations were symptomatic of fundamental inadequacies in the management policies, audit practices and compliance procedures of both institutions.[335] The foregoing evidence from thrift, bank and ILC failures creates serious doubts regarding the ability of existing restrictions on affiliate transactions and insider lending to prevent abusive and unsound transactions between ILCs and their corporate owners.[336]

Moreover, "the restrictions in sections 23A and 23B are complicated and difficult to enforce, and . . . managerial evasions of those provisions" are often subtle and difficult to detect.[337] The challenges of detecting abusive affiliate transactions are magnified when a large commercial firm controls an FDIC-insured bank. As one analyst observed:

> Given that the banking regulators are already overburdened with the task of controlling bank soundness, it is quite unrealistic to expect them to monitor and detect more subtle bias in the vast array of loans that banks would make to commercial affiliates, their suppliers and their customers if the mixing of banking and commerce were permitted.[338]

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[332] Wilmarth, *supra* note 212, at 456 n.1058. Continental's rescue of its subsidiary occurred only three years after federal regulators organized a TBTF bailout of the bank. Wilmarth, *supra* note 236, at 994.

[333] GAO-ILC REPORT, *supra* note 39, at 59 (discussing failures of Pacific Thrift and Loan in 1999 and Southern Pacific Bank in 2003).

[334] FDIC OFFICE OF INSPECTOR GEN., MATERIAL LOSS REVIEW OF THE FAILURE OF SOUTHERN PACIFIC BANK, AUDIT REPORT NO. 03-036, at 11–13, 68, 88, app. IV (2003), *available at* http://www.fdicig.gov/reports03/03-036.pdf [hereinafter SOUTHERN PACIFIC BANK MLR]; FDIC OFFICE OF INSPECTOR GEN., MATERIAL LOSS REVIEW—THE FAILURE OF PACIFIC THRIFT AND LOAN COMPANY, AUDIT REPORT NO. 00-022, at 5, 8, 14, 28–29 (2000), *available at* http://www.fdicig.gov/reports00/00-022.pdf [hereinafter PACIFIC THRIFT MLR].

[335] *See* GAO-ILC REPORT, *supra* note 39, at 60 tbl.5; PACIFIC THRIFT MLR, *supra* note 334, at 8–19, 30–33; SOUTHERN PACIFIC BANK MLR, *supra* note 334, at 11–22.

[336] *See* GAO-ILC REPORT, *supra* note 39, at 62 (reporting the view of FRB officials that "focusing supervisory efforts on transactions covered by sections 23A and 23B will not cover the full range of risks that insured institutions are exposed to from holding companies and their subsidiaries").

[337] Wilmarth, *supra* note 212, at 456, 457 n.1060; *see also* Lemieux, *supra* note 329, at 154–55.

[338] BROWN, *supra* note 315, at 6–7. Under 12 C.F.R. § 223.16(a), a bank must treat a transaction as an affiliate transaction subject to sections 23A and 23B if the proceeds of the transaction "are used for the benefit of, or transferred to" an affiliate." *Id.* at 9. However, "it is questionable whether the [FRB] would have sufficient resources to monitor bank compliance with [section 223.16] in an

The debacles at Lincoln Savings and Enron demonstrate how complex structures can be used to conceal manipulative transactions with affiliates. As previously discussed, the parent company of Lincoln Savings caused the thrift to enter into complicated deals involving sham sales of assets to "straw" buyers. Those deals generated fictitious accounting "profits," which Lincoln then transferred to its parent pursuant to an abusive "tax sharing agreement."[339] Similarly, Enron entered into a myriad of commodity swaps and sales of assets with off-balance-sheet, special-purpose entities that were purportedly independent but were actually controlled by Andrew Fastow, Enron's Chief Financial Officer. Like the Lincoln Savings transactions, Enron's structured-finance deals were elaborate shams that were created for the purpose of producing fictitious profits and deceiving credit ratings agencies and institutional investors.[340] The Lincoln and Enron scandals raise further questions concerning the ability of federal regulators and market professionals to identify and evaluate transactions that are designed to benefit affiliates but are disguised by complex financial structures.

Perhaps most disturbing is the possibility that federal regulators might decide to waive affiliate transaction rules so that ILCs could support their commercial affiliates during a crisis. After the terrorist attacks on September 11, 2001, federal regulators suspended the application of section 23A and encouraged major banks to transfer large amounts of funds to their securities affiliates. The purpose of those transfers was to prevent a liquidity crunch that could have paralyzed the securities markets and threatened the survival of leading securities firms.[341] The ownership of ILCs by giant commercial firms like Wal-Mart and Home Depot increases the likelihood that regulators would similarly feel compelled to waive legal restrictions on affiliate transactions whenever a threat to the parent company's survival raised concerns that the parent's failure might trigger a serious economic crisis.

b. Evidence from Japan, South Korea and Mexico

Major financial crises occurred in Japan, South Korea, and Mexico during the 1990s. Each of those crises was due in part to ownership and control links that existed between banks and commercial firms. Each

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environment involving extensive bank/commercial firm affiliations." *Id.*; *see also id.* at 44 (stating that "serious questions arise as to the [federal banking] agencies' ability to prevent preferential lending and unsound loans in situations where conflicts of interest or external pressures impinge on the credit judgment process").

[339] *See supra* notes 217–23 and accompanying text.

[340] *See* Arthur E. Wilmarth, Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks during the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom* 9–20 (Geo. Wash. Univ. Law School Leg. Stud. Res. Paper No. 234, 2006), *available at* http://ssrn.com/abstract=952486.

[341] Wilmarth, *supra* note 212, at 456–57, 472–73.

episode indicates that joint control of banks and commercial firms creates conflicts of interest, distorts economic incentives, and increases the risk of a systemic crisis.

From the 1950s through the 1990s, the "main bank system" in Japan was primarily responsible for allocating credit within the Japanese economy. Under this system, a main bank acted as the lead lender and principal outside monitor for each commercial firm in which the bank held a significant equity stake and maintained other business relationships. Those relationships typically were cemented by an intricate web of cross-shareholding arrangements between the main bank and other members of its corporate group (*keiretsu*).[342] During the 1980s, the Japanese government followed a liberal monetary policy and gradually deregulated the financial markets to accommodate competitive pressures within the Japanese and international economies. Large corporations were allowed to issue bonds in the Japanese and Eurobond markets and reduced their reliance on bank loans. In response to a declining demand for credit from major corporations, the main banks and other banks greatly expanded their lending to small and medium-sized businesses. Rapid growth in bank credit helped to promote asset bubbles in the Japanese real estate market and stock market during 1985–1989. Japanese banks responded to rising asset values by extending additional credit to real estate developers and to corporations and individuals for speculation in the securities markets. Japanese banks also expanded their own investments in the stock market to strengthen their *keiretsu* relationships and to improve their Tier 2 regulatory capital under the Basel Capital Accord of 1988.[343]

The Bank of Japan's decision to tighten monetary policy in 1989 triggered a progressive collapse of the real estate and stock markets. Real estate values and stock market prices fell by more than 50% during the

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[342] *See generally* Masahiko Aoki, Hugh Patrick & Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, *in* THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES 1, *passim* (Masahiko Aoki & Hugh Patrick eds., 1994); BROWN, *supra* note 315, at 35–42; Curtis J. Milhaupt, *Commentary: On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 J. L. & SOC. INQUIRY 425, 428–35 (2001); Joe Peek & Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan*, 95 AM. ECON. REV. 1144, 1145–46 (2005). For example, a 1996 survey found that 30.7% of the "large" shareholders of publicly-traded Japanese firms were either parent companies or companies in the same *keiretsu*, and 35.6% of the "large" shareholders were financial institutions having business relationships with the firms. Milhaupt, *supra*, at 429.

[343] *See, e.g.*, Aoki, Patrick & Sheard, *supra* note 342, at 46–48; Mitsuhiro Fukao, *Japan's Lost Decade and its Financial System*, 26 WORLD ECON., Mar. 2003, at 365, 366–68; Yoshinori Shimizu, *Convoy Regulation, Bank Management, and the Financial Crisis in Japan*, *in* JAPAN'S FINANCIAL CRISIS AND ITS PARALLELS TO U.S. EXPERIENCE 57, 58–75, 81–84 (Ryoichi Mikitani & Adam S. Posen eds., 2000); Adrian van Rixtel et al., *Banking in Japan: Will Too Big to Fail Prevail?*, *in* TOO BIG TO FAIL, *supra* note 284, at 253, 254–64; Wilmarth, *supra* note 96, at 613–14.

1990s and did not begin to recover until 2004.[344] The collapse of asset values caused a wave of business bankruptcies and inflicted massive losses on Japanese banks. Two city banks, two long-term credit banks and several regional banks failed or were nationalized during 1995–2003.[345] By 2003, Japanese banks had suffered loan losses of about $750 billion.[346] Between 1995 and 2003, the Japanese government spent at least $450 billion to assist banks and recapitalize the deposit insurance fund.[347] The government provided a full guarantee for time deposits until 2002 and for demand deposits until 2003.[348] The government spent an additional $1 trillion on economic stimulus programs, but the Japanese economy remained mired in a deep slump until a recovery finally began in 2004.[349]

Analysts have offered many reasons for the severity and prolonged nature of Japan's economic crisis. Three of those reasons are relevant to this Article. First, the cross-shareholding and lending relationships between Japanese banks and their business customers meant that the financial and commercial sectors in Japan were closely linked in 1989. Problems arising in one sector inevitably spilled over into the other. Thus, the tightly interwoven ownership and credit linkages between banks and their commercial customers significantly increased Japan's vulnerability to a systemic economic crisis.[350]

Second, due to the tremendous financial and political costs of dealing with the banking crisis, Japanese regulators and politicians adopted a variety of forbearance measures designed to postpone the day of reckoning. In this regard, they acted in a manner that was very similar to the actions of U.S. regulators and politicians during the savings and loan crisis of the 1980s. Japanese officials did not directly confront the banking industry's problems until large banks began to fail in 1997–1998.[351]

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[344] *See* HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 205 (12th ed. 2005); Takeo Hoshi & Anil K. Kashyap, *Japan's Financial Crisis and Economic Stagnation*, 18 J. ECON. PERSP. No. 1, Winter 2004, at 3, 5–6; Shimizu, *supra* note 343, at 71–76.

[345] *See* SCOTT, *supra* note 344, at 210–15, 222–24; Fukao, *supra* note 343, at 370–72; van Rixtel et al., *supra* note 343, at 267–78.

[346] *See* Hoshi & Kashyap, *supra* note 344, at 12 (reporting cumulative loan losses of 91.5 trillion yen). The exchange rate between the yen and the dollar was approximately 120 yen to $1 dollar during 1995–2003. *Id.* at 10 n.6.

[347] *See* Fukao, *supra* note 343, at 369–72 (stating that the Japanese government spent 27 trillion yen to support banks and 27 trillion yen to recapitalize the deposit insurance fund); *compare* SCOTT, *supra* note 344, at 215 (estimating that the Japanese government may have spent more than 90 trillion yen for those purposes).

[348] *See* Fukao, *supra* note 343, at 372.

[349] *See* SCOTT, *supra* note 344, at 205, 210–11, 239–40; Hoshi & Kashyap, *supra* note 344, *passim*; Wilmarth, *supra* note 212, at 451–52; Wilmarth, *supra* note 96, at 614.

[350] Wilmarth, *supra* note 212, at 451–52; *see id.* at 453 n.1048 (citing additional sources for the reader's reference).

[351] SCOTT, *supra* note 344, at 210–15, 220–24; Benjamin M. Friedman, *Japan Now and the United States Then: Lessons from the Parallels*, *in* JAPAN'S FINANCIAL CRISIS, *supra* note 343, at 37, 47–53; Fukao, *supra* note 343, at 368–72; van Rixtel et al., *supra* note 343, at 268–75.

Third, in order to avoid recognizing loan losses and to support their most important borrowers, Japanese banks followed a policy of "evergreening"—i.e. banks kept rolling over or restructuring loans that were in default. A recent study found that, during 1993–1999, Japanese banks were more likely to evergreen loans if (i) they had a large credit exposure to the borrower, (ii) the borrower was a member of the bank's *keiretsu*, (iii) the borrower was in weak condition, or (iv) the borrower did not have access to the bond markets and was therefore dependent on bank loans. In addition, main banks were more likely than secondary banks to help their borrowers, especially if the borrowers belonged to the main bank's *keiretsu*.[352] Thus, a major reason for the Japanese economy's failure to improve during the 1990s was that main banks focused their lending on borrowers that were in the weakest condition and were most closely connected to the banks. As a consequence, bank credit was misdirected toward "zombie" firms, and credit was denied to more profitable firms that did not have close connections to banks.[353] In sum, Japan's experience indicates that control linkages between banks and commercial firms seriously distrort the allocation of credit, increase the economy's vulnerability to systemic crises and impede the economy's ability to recover from an economic downturn.

South Korea's financial crisis of 1997–1998 offers striking parallels to Japan's travails. Like Japan, South Korea maintained a bank-centered financial system from the 1950s through the 1990s, and South Korea's system contained similar cross-sharing networks and lending relationships between main banks and dominant corporate groups (*chaebol*).[354] South Korea began to deregulate its financial system in the early 1980s by transferring commercial banks from government to private ownership. Even though the banks were privatized, they continued to make loans to *chaebol* firms and other businesses in accordance with government policies that funneled credit to heavy industries and producers of goods intended for export markets. As the government progressively liberalized its financial regulations during the 1990s, Korean commercial banks and newly-organized merchant banks continued to expand their lending to

[352] *See* Peek & Rosengren, *supra* note 342, at 1150–65.

[353] *See* Ricardo J. Caballero et al., *Zombie Lending and Depressed Restructuring in Japan passim*, (Mass. Inst. of Tech., Working Paper No. 06-06, 2006), *available at* http://ssrn.com/abstract=889727; Hoshi & Kashyap, *supra* note 343, at 14–15; Peek & Rosengren, *supra* note 342, at 1164–65.

[354] The Korean Fair Trade Commission defines a *chaebol* as "a group of companies, more than 30 percent of whose shares are owned by some individuals or by companies controlled by those individuals." Eduardo Borensztein & Jong-Wha Lee, *Financial Crisis and Credit Crunch in Korea: Evidence From Firm-Level Data*, 49 J. MONETARY ECON. 853, 862 n.17 (2002). The top-30 *chaebol* produced about 16% of GDP and 40% of manufacturing output in Korea in the mid-1990s. *Id.* at 862.

Korean businesses.[355] Bank credit to private sector borrowers in South Korea increased from 36.3% of GDP in 1980 to 65.6% of GDP in 1997.[356]

By the mid-1990s, the thirty largest *chaebol* were highly leveraged, as their average debt-equity ratio exceeded 500%.[357] The *chaebol* relied on overly-generous bank credit to build up excess capacity in steel, shipbuilding, automobiles and semiconductors—industries that were vulnerable to competition from lower-cost foreign suppliers.[358] Korean banks were also fragile, because they relied heavily on loans from foreign banks. By 1997, foreign banks had extended $104 billion of credit to Korean borrowers, including $68 billion in loans to Korean banks. Thus, both the *chaebol* and their Korean bank sponsors were highly vulnerable to a sudden withdrawal of international credit.[359]

The economic crisis that struck Thailand, Indonesia and Malaysia in 1997 led to increasing concerns among foreign investors and foreign banks about the solvency of Korean banks and businesses. Foreign banks reduced their credit lines to Korean borrowers, and foreign investors began to liquidate their Korean investments.[360] The Korean stock market crashed, leading to a wave of corporate failures. Eight *chaebol* declared bankruptcy in 1997, along with more than 17,000 Korean firms. In 1998, over 36,000 Korean firms declared bankruptcy. Daewoo, one of the five largest

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[355] For descriptions of the South Korean financial system before the 1997 crisis, see Bernard Black et al., *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J. CORP. L. 537, 540–42, 550–52 (2001); Curtis J. Milhaupt, *Privatization and Corporate Governance in a Unified Korea*, 26 J. CORP. L. 199, 205–08 & tbl.1 (2001) (reporting that families and affiliated firms owned 43% of the shares of publicly-traded companies in the thirty largest *chaebol* in 1997); Joseph Bisignano, *Precarious Credit Equilibria: Reflections on the Asian Financial Crisis* 11–19, 32 tbl.4, 34–35 (Bank for Int'l Settlements, Working Paper No. 64, 1999), *available at* http://ssrn.com/abstract=850072; Joonho Hahm, *The Korean Model of Corporate Governance: Issues and Lessons in Reform of Bank Governance* 2–4 (Hills Governance Ctr. at Yonsei Univ., Working Paper No. 05-01, 2005), *available at* http://ssrn.com/abstract=799644.

[356] Bisignano, *supra* note 355, at 9 tbl.1.

[357] *See id.* at 35.

[358] Catherine H. Lee, *To Thine Ownself Be True: IMF Conditionality and Erosion of Economic Sovereignty in the Asian Financial Crises*, 24 U. PA. J. INT'L ECON. L. 875, 889–91 (2003); Doowoo Nam & Benton E. Gup, *The Economic Crisis of South Korea*, *in* INTERNATIONAL BANKING CRISES: LARGE-SCALE FAILURES, MASSIVE GOVERNMENT INTERVENTIONS 107, 116–17 (Benton E. Gup ed., 1999).

[359] Bisignano, *supra* note 355, at 29, 31, 34–35, 41–42; s*ee also* Borensztein & Lee, *supra* note 354, at 858 tbl.1 (showing that the liabilities of Korean commercial banks to foreign creditors doubled during 1995–1997).

[360] *See id.* at 5, 10–11, 24 tbl.3, 38–42; Black et al., *supra* note 355, at 553; Graciela L. Kaminsky et al., *The Unholy Trinity of Financial Contagion*, 17 J. ECON. PERSP. NO. 4, Fall 2003, at 51, 59–63, 68–70; *see also* Borensztein & Lee, *supra* note 354, at 858 tbl.1 (showing that the liabilities of Korean commercial banks to foreign creditors fell by 30%during 1997–1998); *id.* at 861 (explaining that "as foreign lines of credit dried up, [Korean] banks had no choice but to repay their short-term foreign debts, or later repay the emergency support that the Bank of Korea had provided on a temporary basis").

chaebol, collapsed in 1999.[361] Two large banks failed and were nationalized by the South Korean government in January 1998. The government also provided support for five acquisitions of failing banks in June 1998.[362] The government protected all depositors and ultimately spent about $100 billion to restructure and recapitalize the Korean banking system.[363]

Thus, the Korean crisis of 1997–1998, like the Japanese debacle, can be traced in substantial part to incestuous ownership and credit links between banks and large corporate groups. Korean banks, like Japanese banks, continued to extend credit to their principal corporate borrowers long past the point of prudence. A recent study of the stock market performance of Korean firms during the 1997–1998 crisis found that the greatest losses in share value occurred among firms that either (i) were members of *chaebol* in which owner-managers and affiliated firms had high levels of share ownership, or (ii) were more dependent on bank loans, especially from main banks.[364] Another study found that, compared to non-*chaebol* firms, publicly-traded companies that were members of the thirty largest *chaebol* (i) received loans with preferential terms during 1996–1997, (ii) had significantly higher debt/asset ratios in 1997, and (iii) produced substantially lower earnings after the onset of the crisis.[365] The foregoing studies confirm that preferential lending by Korean banks to *chaebol* firms played a key role in planting the seeds of South Korea's financial crisis.

Similarly, preferential lending by banks to related entities was an important factor in the Mexican financial crisis of 1994–1995. In 1982, Mexico nationalized its banks when the government defaulted on its sovereign debt. During the 1980s, Mexico recapitalized and consolidated

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[361] Black et al., *supra* note 355, at 541–42, 553; Borensztein & Lee, *supra* note 354, at 854; Nam & Gup, *supra* note 358, at 114–16, 121; *see also* Borensztein & Lee, *supra* note 354, at 854 (stating that GDP fell by 6.7% and fixed investment declined by 40% in Korea during 1998).

[362] Sungho Choi & Iftekhar Hasan, *Ownership, Governance, and Bank Performance: Korean Experience*, 14 FIN. MKTS, INSTITS. & INSTRUMENTS 215, 217–18 (2005).

[363] Wilmarth, *supra* note 212, at 308–09.

[364] Jae-Seung Baek et al., *Corporate Governance and Firm Value: Evidence From the Korean Financial Crisis*, 71 J. FIN. ECON. 265, 269, 272, 294–97, 301–02 (2004).

[365] *See* Borensztein & Lee, *supra* note 354, at 855, 863, 864 tbl.2, 869–70, 873 (2002). The same study found that publicly-traded *chaebol* firms lost their preferential access to bank credit after the Korean financial crisis began. *Id.* at 867–70, 873. Thus, Korean banks (unlike Japanese banks) evidently did not engage in widespread "evergreening" to prop up their principal borrowers during or after the crisis. *See id.* at 861, 873. This difference in bank lending behavior may result from the fact that Korean regulators and Korean banks were subject to stricter international scrutiny after the crisis began. Unlike Japan, Korea was obliged to accept a $58 billion financial support package coordinated by the International Monetary Fund (IMF). The IMF package included conditions that required Korea to make fundamental reforms in a number of areas, including a restructuring of its financial sector and improvements in its corporate governance rules. *See* Lee, *supra* note 358, at 892–94; *see also* Black et al., *supra* note 355, at 542–44, 554–58 (describing the Korean government's corporate governance reforms).

its banks, reducing their number from fifty-eight to eighteen.[366] The government also sold the banks' non-banking lines of business (including insurance and securities brokerage units) to private parties. During 1991–1992, the government conducted auctions and sold the eighteen banks to private parties for $12.4 billion.[367] Although the privatization law prohibited corporations from owning banks, the government sold the banks to powerful Mexican families who also controlled the leading industrial groups and securities firms.[368] For example, the board of directors of Banco Serfin, the third largest bank, was dominated by the Gonzáles family and included the controlling shareholders of fifteen publicly-traded Mexican companies.[369]

The newly-privatized banks aggressively expanded their lending in an attempt to gain market share in the deregulated Mexican financial markets. During 1988–1994, private sector lending by the banks grew by 25% per year.[370] Due to "supercompetitive" conditions created by the government's privatization and deregulation programs, interest rate spreads between loans and deposits declined steadily at Mexican banks between 1990 and 1994.[371] Banks and depositors had few concerns about risks, because the newly-established Mexican deposit insurance agency (FOBAPROA) guaranteed all deposits. In addition, bank supervision was lax and inadequate, and banks typically rolled over delinquent loans or restructured such loans by capitalizing past-due interest. Thus, banks expected forbearance from their regulators, and borrowers expected forbearance from their banks.[372]

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[366] William C. Gruben & Robert McComb, *Liberalization, Privatization, and Crash: Mexico's Banking System in the 1990s*, FED. RES. BANK OF DALLAS ECON. REV., First Quarter 1997, at 21, 22–23, *available at* http://www.dallasfed.org/research/er/1997/er9701c.pdf.

[367] William C. Gruben & Robert P. McComb, *Privatization, Competition, and Supercompetition in the Mexican Commercial Banking System*, 27 J. BANKING & FIN. 229, 244 n.14 (2003); Elizabeth McQuerry, *The Banking Sector Rescue in Mexico*, FED. RES. BANK OF ATLANTA ECON REV., Third Quarter 1999, at 14, 15.

[368] Gelpern, *supra* note 32, at 1521; Gruben & McComb, *supra* note 367, at 230; *see also* Stephen Haber, *Mexico's Experiments with Bank Privatization and Liberalization*, *1991–2003*, 29 J. BANKING & FIN. 2325, 2326–31 (2005) (describing the history and process of Mexico's bank privatization); Rafael La Porta et al., *Related Lending*, 118 Q. J. ECON. 231, 244–47 (2003) (describing the acquisition and control of banks by local families).

[369] The González family and the other directors and officers of Banco Serfin controlled more than half of the bank's shareholder votes. Eleven of the bank's forty-four directors were related by blood or marriage. La Porta et al., *supra* note 368, at 245–46.

[370] McQuerry, *supra* note 367, at 16 (reporting in addition that mortgage loans expanded by 47% and credit card liabilities grew by 30% per year during 1988-94).

[371] Gruben & McComb, *supra* note 366, at 25; Gruben & McComb, *supra* note 367, at 230–36.

[372] Gruben & McComb, *supra* note 366, at 26; Haber, *supra* note 368, at 2331–33, 2338; La Porta et al., *supra* note 368, at 246–47; McQuerry, *supra* note 367, at 16, 18.

Like the Korean banks, Mexican banks relied heavily on foreign credit to expand their loans to Mexican businesses and consumers.[373] The reckless lending practices of Mexican banks produced a sharp increase in their nonperforming loans during 1991–1994, even before the onset of the peso exchange rate crisis.[374] In addition, the banks extended many of their loans to controlling shareholders and their affiliates.[375] Accordingly, the banks were highly vulnerable to a downturn in the Mexican economy in 1994.[376]

In response to the exchange rate crisis that began in December 1994, the Mexican government devalued the peso and imposed highly restrictive monetary and credit policies. The government's policies produced a dramatic rise in interest rates. Higher interest rates and the peso's devaluation pushed many borrowers into insolvency (especially if they held dollar-denominated loans) and triggered a massive wave of loan defaults. Nonperforming bank loans doubled by 1995 and tripled by 1996, compared to their level in 1994.[377] To prevent a collapse of the Mexican banking system, the government injected large amounts of capital into the banks and encouraged them to sell nonperforming loans to FOBAPROA. In addition, the government guaranteed all deposits. Thirteen of the eighteen banks essentially failed and were either taken over by the government or acquired by other banks in supervisory mergers. For the first time, the government allowed foreign banks to buy controlling interests in Mexican banks. Ultimately, foreign banks acquired four of the five largest banks in Mexico and controlled close to 80% of Mexico's banking assets by the end of 2003.[378] Estimates for the total cost of

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[373] Haber, *supra* note 368, at 2338 (reporting that during 1991–1994, the foreign liabilities of Mexican banks increased from 11% to 27% of their total liabilities).

[374] Gruben & McComb, *supra* note 366, at 26 (stating that the banks' reported ratio of past-due loans rose from 5.5% to 8.3% during 1992–1994); Haber, *supra* note 368, at 2338 (estimating that 17.1% of the banks' loans were effectively in nonperforming status by December 1994).

[375] For example, twelve of the twenty largest loans made by Banco Serfin were made to directors of the bank or their associates. La Porta et al., *supra* note 368, at 246; *see also id.* at 247 (stating that, as of 1993, the average Mexican bank had extended 13% of its largest 300 loans to related parties).

[376] Haber, *supra* note 368, at 2339; McQuerry, *supra* note 367, at 17.

[377] Haber, *supra* note 368, at 2335, 2339 (discussing the devaluation of the peso and the rise in interest rates, and estimating that nonperforming bank loans rose from 17% of all bank loans in 1994 to 36% in 1995 and 53% in 1996).

[378] Gelpern, *supra* note 32, at 1521; Haber, *supra* note 368, at 2332–33, 2340–44 (noting that "[t]he entry of foreign banks into the Mexican market succeeded in recapitalizing the banking system"); La Porta, *supra* note 368, at 247. Effective January 1, 2005, a new deposit insurance scheme took effect in Mexico. In contrast to the unlimited guarantee provided by FOBAPROA, the new deposit insurance agency, IPAB, imposes a cap of $130,000 on deposit insurance. However, IPAB "has virtually no assets because of the obligations it inherited from the last crisis." Gelpern, *supra* note 32, at 1522; *see* Haber, *supra* note 368, at 2344.

resolving Mexico's banking crisis range between $65 billion and $104 billion.[379]

A study by Rafael La Porta and others determined that loans to related parties were correlated with bank failures, were made on highly preferential terms, and performed much worse than loans to unrelated parties. Compared to the five surviving Mexican banks, the thirteen failed banks had a substantially higher proportion of loans to related parties and their percentage of related loans rose sharply between 1993 and their respective failure dates.[380] Moreover, in comparison with loans made to non-affiliates, loans made by Mexican banks to related parties carried significantly lower interest rates, were much less likely to be backed by collateral or personal guarantees, had a significantly higher default rate, and had a much lower recovery rate.[381] The study concluded that "[t]he case of Mexico in the 1990s suggests that the risk that related lending may lead to looting is great when banks are controlled by industrial firms, outside lending has relatively low rates of return, and corporate governance is weak."[382] In sum, the Mexican financial crisis of 1994–1995—like the Japanese and Korean crises—creates serious doubts about the wisdom of permitting joint control of banks and commercial firms.[383]

3. *Risks of Contagion from Commercial Owners to ILCs*

A further risk confronting a commercially-owned ILC is that its parent company may encounter serious problems that cause the public to lose confidence in the ILC itself. For example, as discussed above, the failure of Caldwell and Company in November 1930 triggered depositor runs on all of its affiliated banks and their correspondent banks. Because there was

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[379] Haber, *supra* note 368, at 2342 (citing an estimate of $65 billion); Wilmarth, *supra* note 212, at 309 n.384, (citing *Fasten Seatbelts*, ECONOMIST, Nov. 6, 1999, at 77, *available at* LEXIS, News Library, ECON File (quoting estimates of $93 billion and $104 billion)).

[380] La Porta et al., *supra* note 368, at 247, 248 tbl.1, 249 (reporting that the average percentage of related loans among the largest 300 loans was 14% at failed banks in 1993, compared to 10% at survivor banks, and that the average percentage of related loans rose to 27% by the time the failed banks were taken over, compared to only 13% for the survivor banks as of June 1997).

[381] *Id.* at 252–58. The study also found that loans made to the least transparent related parties—i.e., privately-held companies or individuals—had the most preferential terms and the worst rates of default and recovery. *Id.* at 259–61.

[382] *Id.* at 262.

[383] Foreign banking crises in the 1930s similarly indicate that ownership links between banking and commercial firms create a higher risk of systemic financial crises. During the 1930s, nations with prominent universal banks (e.g., Austria, Belgium, France, Italy and Germany) experienced severe banking crises because their banks were weakened by close ownership and lending connections to troubled industries. In contrast, Canada and the United Kingdom—whose banks were barred from securities underwriting and dealing and could not own equity interests in commercial firms—did not experience a significant banking crisis during the 1930s. For a more complete review of this topic, see Wilmarth, *supra* note 96, at 612–13, 644 & n.257 (including sources cited therein).

no deposit insurance in 1930, only two of CAC's affiliated banks were able to survive those runs.[384]

Similarly, Beverly Hills Bancorp (BHB) destroyed public confidence in its subsidiary, Beverly Hills National Bank (BHN Bank), when BHB defaulted on $13 million of commercial paper in December 1973. BHB had used the proceeds of the commercial paper to make loans to a real estate developer. When the developer defaulted on the loans, BHB could not pay off the commercial paper. In announcing its default, BHB assured the public that its own problems would not affect the safety and soundness of BHN Bank. BHN Bank's primary regulator, the Comptroller of the Currency, also publicly stated that the bank was "in solvent condition with satisfactory liquidity."[385] Nevertheless, depositors soon launched "large-scale runs" against BHN Bank, and the bank was sued by customers who had purchased BHB's commercial paper.[386] To prevent BHN Bank's failure, regulators arranged a sale of the bank's assets to Wells Fargo Bank in January 1974. BHN Bank was thereafter liquidated.[387]

Likewise, when Drexel Burnham declared bankruptcy in February 1990, following the collapse of the junk bond market, its problems quickly spread to two of its subsidiaries, which were securities broker-dealers regulated by the SEC. The regulated subsidiaries were solvent at the time of Drexel Burnham's failure, but the SEC was soon obliged to liquidate them after they could not obtain even short-term credit from counterparties or banks.[388] The contagion resulting from the failures of CAC, BHB and Drexel Burnham indicates that investors, depositors and other creditors do not believe that a regulated financial institution can be effectively shielded from serious problems occurring at its parent company.

Problems at U.S. automobile manufacturers have repeatedly caused credit ratings agencies to cut their ratings for the manufacturers' captive finance subsidiaries. During 1991–1992, credit ratings agencies reduced

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[384] *See supra* notes 108–12 and accompanying text (discussing the collapse of CAC in 1930).

[385] Douglas W. Cray, *Bancorp on Coast Reveals Problems*, N.Y. TIMES, Dec. 31, 1973, at 27, *available at* LEXIS, News Library, NYT File (quoting Comptroller of the Currency James E. Smith); *see also In re* Beverly Hills Bancorp, 649 F.2d 1329, 1331–32 (9th Cir. 1981); Anthony Cornyn et al., *An Analysis of the Concept of Corporate Separateness in BHC Regulation from an Economic Perspective*, *in* FEDERAL RESERVE BANK OF CHICAGO, A CONFERENCE ON BANK STRUCTURE AND COMPETITION: PROCEEDINGS, MAY 14–16, 1986, at 174, 186–87 (1986).

[386] Cornyn et al., *supra* note 385, at 187; *In re Beverly Hills Bancorp*, 649 F.2d at 1331–32.

[387] *In re Beverly Hills Bancorp*, 649 F.2d at 1332; Cornyn et al., *supra* note 385, at 187.

[388] *See* William S. Haraf, *The Collapse of Drexel Burnham Lambert: Lessons for the Bank Regulators*, REGULATION, Winter 1991, at 22, 23–24; Wilmarth, *supra* note 212, at 327–28, 412, 446 n.1029 (noting that Drexel Burnham's bankruptcy followed the crash of the junk bond market in 1990 and triggered a cutoff of credit to its solvent securities subsidiariest); *see also* BROWN, *supra* note 315, at 23 (quoting SEC chairman Richard Breeden's testimony before a Senate committee, in which he stated that Drexel Burnham's insolvency "appears to have shattered the trust and confidence of the dealer and banking community in the subsidiary broker-dealer, even though it remained solvent with considerable excess liquid assets").

the ratings of Chrysler Financial Corp. (CFC) to junk bond levels and thereby cut off CFC's ability to issue commercial paper, because of serious financial and operational problems at CFC's parent, Chrysler Corporation.[389] Similarly, in recent years Ford Motor Credit Company (FMCC) lost its investment-grade rating and was downgraded to junk bond status because of doubts among ratings agencies about the long-term viability of FMCC's parent, Ford Motor Company (Ford).[390] General Motors Acceptance Corporation (GMAC), the finance subsidiary of General Motors Corporation (GM), also saw its credit ratings fall to junk bond levels because of the ratings agencies' concerns about GM's severe challenges.[391]

In 2006, GM agreed to sell a majority stake in GMAC to an outside investor group for $14 billion.[392] GM needed the sale proceeds to help finance its restructuring program, and GM also hoped that its sale of control of GMAC would improve GMAC's chances of regaining investment-grade status.[393] GMAC had acquired a Utah-chartered ILC in 2004, and GM therefore applied to the FDIC for permission to transfer control of the ILC to GMAC's new majority owner.[394] In November 2006, despite the FDIC's initial moratorium covering all ILC applications, the

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[389] *See* Doron P. Levin, *Chrysler Unit Still on Block After Rebuff by Mitsubishi*, N.Y. TIMES, Mar. 19, 1991, at D16, *available at* LEXIS, News Library, NYT File (noting that Chrysler Financial was prohibited from obtaining public debt because of "its parent's shaky financial condition"); Doron P. Levin, *Little Room for Error in Chrysler's Future*, N.Y. TIMES, Mar. 7, 1991, at D1, D5, *available at* LEXIS, News Library, NYT File (attributing Chrysler Financial's inability to borrow in the public debt market to the downgrade of its and Chrysler Corporation's debt to "junk bond" status); *Ratings Are Cut on $100 Billion of G.M. and Chrysler Debt*, N.Y. TIMES, Jan. 8, 1992, at D2, *available at* LEXIS, News Library, NYT File (observing that Chrysler had to pay a higher interest rate because its credit ratings had fallen to junk-grade levels); David Siegel, *Chrysler Unit Asks Bank Group to Extend $6.8 Billion Credit Line*, AM. BANKER, May 22, 1992, *available at* LEXIS, News Library, AMBNKR File (same).

[390] Cynthia Koons & Simona Covel, *Ford Credit Keeps Debt Ball Rolling*, WALL ST. J., Dec. 12, 2006, at C6, *available at* LEXIS, News Library, WSJNL File; Tom Sullivan & Simona Covel, *Ford Credit Offers $2.25 Billion Debt*, WALL ST. J., Aug. 4, 2006, at C5, *available at* LEXIS, News Library, WSJNL File; *see also* Matthew Quinn, *S&P Downgrades a Ford Unit*, AM. BANKER, Jan. 6, 2006, at 5, *available at* LEXIS, News Library, AMBNKR File (reporting that Standard & Poor's Corporation (S&P) had lowered FMCC's credit rating to BB-minus, "pushing it deeper into the junk category," and quoting S&P analyst Robert Schulz, who stated that the downgrade reflected "increased skepticism" about Ford's prospects).

[391] Serena Ng et al., *Rating Providers Remain Cautious On GMAC Bonds*, WALL ST. J., Apr. 4, 2006, at C1, *available at* LEXIS, News Library, WSJNL File.

[392] *See* Dennis K. Berman & Lee Hawkins Jr., *GM to Sell GMAC Stake to Cerberus*, WALL ST. J., Apr. 3, 2006, at A3, *available at* LEXIS, News Library, WSJNL File; Lee Hawkins Jr., *GMAC Hopes to Shed "Junk" Baggage*, WALL ST. J., May 12, 2006, at C3, *available at* LEXIS, News Library, WSJNL File; Paul Muolo, *GM Finally Sells Big Stakes in Real Estate Lending Units*, MORTGAGE SERVICING NEWS, May 2006, at 1, *available at* LEXIS, News Library, MORTSN File.

[393] *See* Berman & Hawkins, *supra* note 392; Hawkins, *supra* note 392; Muolo, *supra* note 392.

[394] *See* Statement of Douglas H. Jones, *supra* note 42, at 11 (Attachment 1).

FDIC approved GM's application.[395] In explaining its decision to exempt GM's application from the moratorium, the FDIC stated that "waiting to act until after the expiration of the moratorium could have had a significant adverse effect on GM's restructuring and GM's subsidiaries."[396] The FDIC's approval indicated that the agency felt obliged to make an exception to its moratorium due to "unique circumstances" involving a large and troubled commercial parent company.[397]

It is not inconceivable that Wal-Mart and Home Depot could someday find themselves in positions similar to GM and Ford. The growth rate for Wal-Mart's domestic sales has declined sharply in recent years, because Wal-Mart's superstores have reached a saturation point in its traditional rural markets, and Wal-Mart has encountered significant opposition as it has tried to build superstores in metropolitan markets.[398] Indeed, since 2005 Wal-Mart's sales have grown at a much slower rate than the sales of Target, its main rival.[399] Moreover, Wal-Mart's emphasis on employing nonunionized, part-time workers to reduce its labor costs has produced negative publicity, political opposition and many lawsuits (including a nationwide class action) alleging employment discrimination and unfair labor practices.[400]

Wal-Mart has tried to offset its slowing growth in domestic markets by aggressively expanding its operations in foreign markets. However, Wal-Mart's international efforts have met with mixed success. While Wal-Mart has profitable operations in Brazil, Canada, Mexico and the United

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[395] Press Release, Federal Deposit Insurance Corporation, FDIC Board Approves Change in Control Notice for GMAC Automotive Bank, Midvale, Utah (Nov. 15, 2006), *available at* http://www.fdic.gov/news/news/press/2006/pr06103.html.

[396] *Id.* at 2. As part of the FDIC's approval, GMAC and its ILC agreed to comply with "any changes that the FDIC might make to the regulation and supervision of ILCs . . . once the moratorium has been lifted." *Id.*

[397] *Id.* at 1 ("The FDIC acted on this change of control notice prior to the expiration of the [ILC] moratorium because of the unique circumstances of this case."); *see also* Joe Adler, *Approval for GM ILC Deal Pleases Industry*, AM. BANKER, Nov. 17, 2006, at 4, available at LEXIS, News Library, AMBNKR File (quoting Rep. Paul Gillmor's statement that the FDIC had followed a "pragmatic approach" in approving the transaction, because it was "critical to the health of General Motors").

[398] *See, e.g.*, Hudson, *supra* note 310, at A1; Hudson, *supra* note 309, at C1; *The Bulldozer of Bentonville Slows*, ECONOMIST, Feb. 17, 2007, at 70, *available at* LEXIS, News Library, ECON File.

[399] Michael Barbaro, *Wal-Mart Trips As It Changes A Bit Too Fast*, N.Y. TIMES, Nov. 30, 2006, at A1, *available at* LEXIS, News Library, NYT File; Hudson, *supra* note 309, at C1.

[400] *See, e.g.*, Jon Birger, *The Unending Woes of Lee Scott*, FORTUNE, Jan. 22, 2007, at 118, *available at* LEXIS, News Library, FORTUN File; Abigail Goldman & Nancy Cleeland, *The Wal-Mart Effect*, L.A. TIMES, Nov. 23, 2003, at A1, *available at* LEXIS, News Library, LAT File; Steven Greenhouse & Michael Barbaro, *Wal-Mart to Add More Part-Timers and Wage Caps*, N.Y. TIMES, Oct. 2, 2006, at A1, *available at* LEXIS, News Library, NYT File; *see also* Gary McWilliams & Ann Zimmerman, *Wal-Mart to Fight Ruling in Suit*, WALL ST. J., Feb. 7, 2007, at A3, *available at* LEXIS, News Library, WSJNL File (reporting on a decision by the Ninth Circuit Court of Appeals which upheld a district court order granting class-action status to a lawsuit alleging sex discrimination by Wal-Mart filed on behalf of more than 1.5 million past and present female employees).

Kingdom, it withdrew from Germany and South Korea in 2006 after suffering heavy losses.[401] Wal-Mart has made its biggest overseas push in China, where it has acquired a substantial chain of retail stores.[402] In addition, about 70% of the products Wal-Mart sells are produced in China. Because of its increasing dependence on China, Wal-Mart is exposed to substantial risk from either a significant upward revaluation of the Chinese yuan or a major disruption in the Chinese economy.[403]

Home Depot's results in 2006 were even more disappointing than Wal-Mart's. Home Depot's annual net profit declined in 2006 for the first time in the company's history.[404] Like Wal-Mart, the growth of Home Depot's sales has slowed considerably as its rapid expansion during the prior two decades has apparently reached a saturation point. In addition, Home Depot pursued an ill-conceived cost reduction program that replaced skilled, full-time employees with inexperienced, part-time workers. The resulting decline in service quality alienated many of Home Depot's customers, who migrated to Lowe's (Home Depot's principal competitor).[405] Home Depot also launched a wholesale-supply business that produced disappointing earnings and consumed resources that should have been invested in Home Depot's core home-improvement business. As a result of these setbacks, the chairman of Home Depot was forced to step down at the beginning of 2007.[406]

The recent problems experienced by Wal-Mart and Home Depot—like the much greater difficulties confronting GM and Ford—demonstrate that no manufacturer or retailer is "too big" to be immune from the threat of failure in a globalized and highly competitive economy. Two of the largest U.S. retailers—Kmart and Montgomery Ward—filed for bankruptcy during the domestic economy's most recent downturn during 2000–

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[401] *See* Michael Barbaro, *Wal-Mart Profit Falls 26%, Its First Drop in 10 Years*, N.Y. TIMES, Aug. 16, 2006, at C3, *available at* LEXIS, News Library, NYT File; Mark Landler, *Wal-Mart to Abandon Germany*, N.Y. TIMES, July 29, 2006, at C1, *available at* LEXIS, News Library, NYT File; *Special Report Wal-Mart: How Big Can it Grow?*, *supra* note 310.

[402] *See* Keith Naughton et al., *The Great Wal-Mart of China*, NEWSWEEK, Oct. 30, 2006, at 50, *available at* LEXIS, News Library, NWEEK File; *Wal-Mart Buys a Stake in China Chain*, WALL ST. J., Feb. 28, 2007, at B3, *available at* LEXIS, News Library, WSJNL File.

[403] *See* Tom Bliley, *GLB Was Not An Invitation to Wal-Mart*, AM. BANKER, Jan. 27, 2006, at 17, *available at* LEXIS, News Library, AMBNKR File.

[404] Zimmerman & Lloyd, *supra* note 309, at A2.

[405] Brian Grow et al., *Out at Home Depot: Behind the Flameout of Controversial CEO Bob Nardelli*, BUS. WEEK, Jan. 15, 2007, at 56, *available at* LEXIS, News Library, BUSWK File; Joann Lublin et al., *Moving Out: Behind Nardelli's Abrupt Exit*, WALL ST. J., Jan. 4, 2007, at A1, *available at* LEXIS, News Library, WSJNL File; Zimmerman, *supra* note 309, at D1; Ann Zimmerman, *The Home Depot Fix-Up: More Problems Remain after CEO's Departure*, WALL ST. J., Jan. 5, 2007, at C1, *available at* LEXIS, News Library, WSJNL File.

[406] *See* Zimmerman & Lloyd, *supra* note 309, at A2; Ann Zimmerman & Joann S. Lublin, *Home Depot Bows to Whitworth Again: Chain May Sell or Spin Off Wholesale-Supply Unit in a Reversal of Strategy*, WALL ST. J., Feb. 13, 2007, at A3, *available at* LEXIS, News Library, WSJNL File.

2002.[407] Fortunately, neither company owned an FDIC-insured depository institution at the time of its failure.

In addition to the challenges confronting manufacturers and retailers in their core businesses, their efforts to diversify into financial services have often produced disappointing results. In 1985, Ford bought First Nationwide, a large thrift institution, but Ford sold the thrift in 1994 after it repeatedly generated losses rather than earnings.[408] In 1989, Ford acquired Associates First Capital, a subprime consumer lender. However, Ford spun off Associates nine years later, after its lending operations resulted in high delinquency rates and widespread accusations of unfair and deceptive practices.[409]

Similarly, Sears built a "financial supermarket" during the 1980s by acquiring a thrift (Sears Savings Bank), an insurance company (Allstate), a securities broker (Dean Witter), a credit card company (Discover), and a real estate broker and mortgage banker (Coldwell Banker). However, Sears sold or spun off all those units by the early 1990s after they failed to

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[407] Danny Hakim & Leslie Kaufman, *Kmart Files Bankruptcy, Largest Ever for a Retailer*, N.Y. TIMES, Jan. 23, 2002, at C1, *available at* LEXIS, News Library, NYT File; Leslie Kaufman & Claudia H. Deutsch, *Montgomery Ward to Close Its Doors*, N.Y. TIMES, Dec. 29, 2000, at C1, *available at* LEXIS, News Library, NYT File. Kmart emerged from bankruptcy in May 2003, when it was bought by hedge fund investor Edward Lampert, who also acquired control of Sears in November 2004. *See* Amy Merrick & Dennis K. Berman, *Attention, Shoppers: Kmart to Buy Sears for $11.5 Billion*, WALL ST. J., Nov. 18, 2004, at A1, *available at* LEXIS, News Library, WSJNL File. However, analysts have questioned whether Kmart and Sears will be able to regain their former prominence and achieve long-term success as national retailers. *See, e.g.*, Jesse Eisinger, *Long & Short: Lampert Faces a Long Shot in Reviving Sears*, WALL ST. J., Sept. 14, 2005, at C1, *available at* LEXIS, News Library, WSJNL File; Mya Frazier, *Since picking up Kmart, It's Been Tears for Sears*, ADVERTISING AGE, Jan. 22, 2007, at 8, *available at* LEXIS, News Library, ADAGE File; Gretchen Morgenson, *The Sears Catalog of Problems*, N.Y. TIMES, Nov. 6, 2005, § 3, at 1, *available at* LEXIS, News Library, NYT File.

[408] *See* Jim McTague, *Ex-Chairman Sees Ford in Banking for Long Haul*, AM. BANKER, Oct. 25, 1991, *available at* LEXIS, News Library, AMBNKR File (reporting on losses by First Nationwide during 1991); Sam Zuckerman, *14% Rise in Bad Realty Loans Spurs Loss at 1st Nationwide*, AM. BANKER, Oct. 31, 1990, at 1, *available at* LEXIS, News Library, AMBNKR File (stating that "the thrift has produced a series of disappointments" since Ford bought it in 1985); Sam Zuckerman, *Texan to Pay $1 Billion for Ford's Big Thrift*, AM. BANKER, Apr. 15, 1994, at 1, *available at* LEXIS, News Library, AMBNKR File (stating that "selling First Nationwide is an embarrassing retreat for Ford," and Ford would incur a net loss on the sale after recording a $440 million charge).

[409] *See* Antoinette Coulton, *Aggressive Ford Unit Now a Driving Force: Portfolio Deals Have Raised Associates' Profile, but Picture Isn't All Rosy*, AM. BANKER, Feb. 20, 1997, at 24, *available at* LEXIS, News Library, AMBNKR File; *Ford Spins Off B&C Unit*, NAT'L MORTGAGE NEWS, Oct. 13, 1997, at 1; Heather Timmons, *CEO: Spinoff Won't Change Associates*, AM. BANKER, Mar. 18, 1998, at 9, *available at* LEXIS, News Library, AMBNKR File. After Citigroup acquired Associates First Capital in 2000, the FTC sued Associates and Citigroup, alleging that Associates had engaged in unfair and deceptive lending and debt collection practices since 1995. In 2002, Citigroup agreed to pay $215 million to settle the FTC's charges. Brian Collins, *Citi Pays $215 Million to Settle Alleged Fraud at Associates*, NAT'L MORTGAGE NEWS, Sept. 23, 2002, at 2; Richard A. Oppel Jr., *U.S. Suit Cites Citigroup Unit on Loan Deceit*, N.Y. TIMES, Mar. 7, 2001, at A1, *available at* LEXIS, News Library, NYT File.

produce the profits and synergies Sears anticipated.[410] Subsequently, Sears sold a large credit card business that it built up during the 1990s, after that unit generated high rates of delinquencies and chargeoffs.[411] A major reason for the credit card unit's problems was that Sears aggressively expanded credit lines and eased credit terms to encourage cardholders to buy more products from Sears.[412] Sears's problems with its credit card unit provide further evidence of the potential dangers in allowing commercial firms to use ILCs as sources of credit to finance the parent companies' product sales.

The highly coordinated marketing strategies of today's conglomerates are yet another factor that increases the risk of contagion within holding companies. Large financial conglomerates and their commercial rivals have adopted unified brands as a key strategy to promote the cross-selling of various products to their customers.[413] Several of the commercial firms that have already acquired ILCs—e.g., BMW, Target, Toyota and Volkswagen—have applied the parent's brand name to the ILC.[414] Similarly, Wal-Mart said that it would use the name "Wal-Mart Bank" for

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[410] Wilmarth, *supra* note 212, at 425–26; Phil Roosevelt, *Sears to Pull Out of Banking, Will Shed Discover Card, Mortgage Operations*, AM. BANKER, Sept. 30, 1992, at 1, *available at* LEXIS, News Library, AMBNKR File.

[411] Robert Berner, *Sears Stock Plunges on Credit-Card Debt Concerns*, WALL ST. J., Oct. 17, 1997, at A3, *available at* LEXIS, News Library, WSJNL File (stating that "Sears has been battling a run-up in bad debt in its proprietary credit-card business"); David Breitkopf, *Sears $30.8B Portfolio is Largest Up for Sale in Years*, AM. BANKER, Mar. 27, 2003, at 7, *available at* LEXIS, News Library, AMBNKR File (reporting on Sears' decision to "sell its increasingly troubled [credit card] portfolio, which has been beset by rising chargeoff rates"); Ken Brown & Amy Merrick, *Towering Expectations Grip Sears Shares*, WALL ST. J., Aug. 20, 2003, at C1, *available at* LEXIS, News Library, WSJNL File (explaining that Sears sold its credit card business after being "hit [in 2002] by big losses on its credit cards").

[412] *See* Joseph B. Cahill, *The Softer Side: Sears's Credit Business May Have Helped Hide Larger Retailing Woes*, WALL. ST. J., July 6, 1999, at A1, *available at* LEXIS, News Library, WSJNL File; Andrew Ross Sorkin, *Sears Is Said To Be Putting Credit Cards Up for Sale*, N.Y. TIMES, Mar. 26, 2003, at C1, *available at* LEXIS, News Library, NYT File; De'Ann Weimer, *Put the Comeback on My Card*, BUS. WK., Nov. 10, 1997, at 118, *available at* LEXIS, News Library, BUSWK File.

[413] *See* Wilmarth, *supra* note 212, at 446–47, 449–50, 457; *see also* J. Lynn Lunsford & Brian Steinberg, *Conglomerates' Conundrum: When It Comes to Ads Aimed at Investors, How Do You Put a Face on the Faceless?*, WALL ST. J., Sept. 14, 2006, at B1, *available at* LEXIS, News Library, WSJNL File (stating that "many successful conglomerates . . . have tried with varying degress of success . . . to create a 'brand' for a parent company"). Major financial conglomerates, including Citigroup, Credit Suisse and UBS, have recently adopted unified brand names for all or most of their important financial service units. *See* Clint Riley, *Citigroup Sells Red Umbrella Logo to St. Paul*, WALL ST. J., Feb. 14, 2007, at B3, *available at* LEXIS, News Library, WSJNL File (reporting that "[a]ll of Citigroup's many businesses now will appear under a unified 'Citi' brand"); Edward Taylor, *Credit Suisse Strategy: Be UBS?*, WALL ST. J., Sept. 14, 2006, at C1, *available at* LEXIS, News Library, WSJNL File (reporting that UBS "operate[s] as a single brand"); Edward Taylor, *Credit Suisse Plans to Eliminate First Boston Name*, WALL ST. J., June 30, 2005, at C5, *available at* LEXIS, News Library, WSJNL File (quoting statement by Credit Suisse's chairman that "we have decided to use one brand, Credit Suisse, for all our banking businesses" in order "to communicate with one face to the market").

[414] *See* Statement of Douglas H. Jones, *supra* note 42, at Attachment 1.

its proposed ILC.[415] Common brand names and cross-selling programs aggravate the risk that consumers, investors and creditors will perceive problems at commercial parent companies as direct threats to the safety and soundness of their captive ILCs.

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

The FDIC currently does not have authority to exercise consolidated supervision over commercial firms that control ILCs.[416] Even if Congress gave the FDIC consolidated supervisory authority over such firms, such a grant of power would create at least four problems. First, the FDIC does not have expertise to identify and control the risks created by commercial firms that are affiliates of ILCs. Second, the FDIC's designation as consolidated supervisor might cause market participants to expect that the federal safety net would be extended to commercial parent companies of ILCs. Third, giving the FDIC authority to supervise the activities of commercial affiliates would significantly increase the amount of governmental interference in the general economy. Fourth, large commercial owners of ILCs are likely to enjoy substantial political influence, which they can use to extract costly subsidies or forbearance measures from legislators and the FDIC.

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

The GAO has provided a comprehensive analysis of the FDIC's authority to regulate commercial firms that own ILCs. That analysis will not be repeated here. For present purposes, it is sufficient to note three significant limitations on the FDIC's authority to supervise an ILC's parent holding company and the nonbank subsidiaries of that company. First, the FDIC has only a limited power to examine the parent company or one of its nonbank subsidiaries. The FDIC may examine an "affiliate" of the ILC—a category that includes the parent company and each of its nonbank subsidiaries—but only to the extent "necessary to disclose fully (i) the relationship between [the ILC] and any such affiliate; and (ii) the effect of such relationship on the [ILC]."[417] Thus, the FDIC's examination authority over the parent company or a nonbank subsidiary is limited to identifying the "relationship" which that company has with the ILC and determining

[415] *See supra* note 6 and accompanying text.

[416] For a detailed discussion of the FDIC's authority to regulate parent companies of ILCs, see GAO-ILC REPORT, *supra* note 39, at 27–65.

[417] 12 U.S.C. § 1820(b)(4)(A) (2000). The term "affiliate" includes any company "that controls, is controlled by, or is under common control with, [an ILC]." 12 U.S.C. §§ 1813(w)(6), 1841(k) (2000).

whether that "relationship" has the potential to harm the ILC. The FDIC does not have authority to examine the parent holding company and its nonbank subsidiaries for the purpose of evaluating the overall safety and soundness of the holding company.[418]

Second, the FDIC cannot impose capital requirements on the parent company of an ILC or on any of its nonbank subsidiaries. The FDIC has authority to establish capital requirements only with respect to state nonmember banks, including ILCs.[419] The FDIC could insist, as a condition of approving an application for deposit insurance, that an ILC's parent company must enter into a capital maintenance agreement with the FDIC. Under such an agreement, the FDIC could require the parent company to maintain the ILC's capital at specified levels in order to preserve the ILC's status as an FDIC-insured bank.[420] However, the FDIC cannot dictate the capital structure of the parent company or its nonbank subsidiaries.[421]

Third, the FDIC has only limited authority to bring administrative enforcement proceedings (including actions for cease-and-desist orders or civil money penalties) against an ILC's parent company or its nonbank subsidiaries.[422] For purposes of its enforcement authority, the FDIC can treat the ILC's parent company as an "institution-affiliated party" (IAP), because that term includes a controlling shareholder (other than a bank holding company) of a state nonmember bank.[423] However, the FDIC cannot treat a nonbank subsidiary of the parent company as an IAP unless it "participates in the conduct of the [ILC's] affairs."[424] In addition, the FDIC may not bring an enforcement action against an IAP unless that person (i) has engaged or is about to engage in an unsafe or unsound practice in conducting the business of the ILC, or (ii) has violated or is about to violate a law, rule or written agreement or condition imposed by the FDIC.[425] Thus, the FDIC's enforcement authority does not extend to nonbank subsidiaries of the parent company that are not IAPs. Moreover,

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[418] *See* GAO-ILC REPORT, *supra* note 39, at 33–35, 38–40.

[419] *See* 12 U.S.C. §§ 1813(q)(3), 1831o(c), 3902(1), 3907(a) (2000).

[420] *See* GAO-ILC REPORT, *supra* note 39, at 36–38, 41–43; *see also* 12 U.S.C. § 1816(2) (listing the "adequacy of the depository institution's capital structure" as one of seven criteria that the FDIC must consider in deciding whether to grant an application for deposit insurance). The FDIC can enforce a capital maintenance agreement by bringing administrative proceedings under 12 U.S.C. § 1818 (2000), or under the prompt corrective action provisions of 12 U.S.C. § 1831o.

[421] *See* GAO-ILC REPORT, *supra* note 39, at 43 (stating that "FDIC officials told us that it has never imposed capital requirements on a holding company").

[422] For the FDIC's authority to bring administrative enforcement actions against state nonmember banks, see 12 U.S.C. §§ 1813(q)(3), 1818(b),(c), (i) (2000); MCCOY, *supra* note 51, § 13.03 (discussing the FDIC's enforcement powers).

[423] 12 U.S.C. § 1813(u)(1) (2000).

[424] *Id.* § 1813(u)(3).

[425] *Id.* § 1818(b)(1), (c)(1), (i)(2).

the FDIC cannot bring action against an IAP based on alleged unsafe or unsound practices that are not directly related to the ILC's business.[426]

In contrast to the limited, "bank-centric" authority of the FDIC over ILCs and their affiliates, the FRB enjoys consolidated supervisory powers over bank holding companies and their nonbank subsidiaries.[427] With certain limitations, the FRB can examine a bank holding company and all of its subsidiaries,[428] and can impose capital requirements on the holding company and all of its nonbank subsidiaries.[429] Under the "source of strength" doctrine, the FRB may require a bank holding company to make capital contributions to a subsidiary bank or to provide other types of financial or managerial support.[430] The FRB can bring administrative enforcement proceedings against a bank holding company or any of its nonbank subsidiaries.[431] In addition, the FRB can require a bank holding company to divest any nonbank subsidiary or any nonbanking activity that presents "a serious risk to the financial safety, soundness, or stability" of one or more of the holding company's subsidiary banks.[432] By virtue of its consolidated supervisory powers, the FRB can take "a systemic approach" that encompasses the bank holding company and all of its nonbank subsidiaries, and that addresses "financial and operations risks within the holding company system that can threaten the safety and soundness of a bank subsidiary."[433]

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

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[426] *See* GAO-ILC REPORT, *supra* note 39, at 34–37, 38 tbl.2, 46–47.

[427] *Id.* at 29–31.

[428] *See* 12 U.S.C. § 1844(c)(2) (2000); *see also* MCCOY, *supra* note 51, § 12.04[1][a][ii] (explaining that, to the fullest extent possible, the FRB is required (i) to limit its examination to the bank holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of the holding company's subsidiary banks, and (ii) to accept examination reports prepared by regulators of functionally regulated subsidiaries of the holding company).

[429] *See* 12 U.S.C. §§ 1813(q)(2)(F), 1831o(c), 3902(1)(A), 3907 (2000); 12 C.F.R. § 225 apps. A–E (2006) (setting forth the FRB's capital requirements for bank holding companies). *But see* 12 U.S.C. § 1844(c)(3) (2000) (limiting the FRB's authority to establish capital requirements for functionally regulated subsidiaries of bank holding companies).

[430] The FRB's "source of strength" doctrine, which is set forth in 12 C.F.R. § 225.4(a)(1) (2007), was implicitly endorsed by Congress in GLBA. MCCOY, *supra* note 51, § 4.05; GAO-ILC REPORT, *supra* note 39, at 32.

[431] *See* 12 U.S.C. §§ 1813(q)(2)(F), 1818(b), (c), (i) (2000).

[432] *Id.* § 1844(e)(1) (2000).

[433] GAO-ILC REPORT, *supra* note 39, at 30, 40.

high-risk loans that ultimately caused PTL's failure in November 1999.[434] Similarly, the FDIC began taking enforcement actions against SPB in September 1996, but did not make an on-site visit to SPB's parent holding company until February 2001. The FDIC discovered that the parent holding company had itself been incurring significant losses since 1998 and therefore could not provide sufficient capital support to prevent SPB from failing in February 2003.[435] The failures of PTL and SPB indicate that

> the bank-centric approach alone is not sufficient to assess all the risks that a holding company and affiliates can pose to an insured financial institution. . . . [In contrast,] consolidated supervision provides [the FRB's] examiners with both the ability to understand the financial strength and risks of the overall [bank] holding company . . . and the authority to address significant management, operations, capital, and other deficiencies throughout the organization before these deficiencies pose a danger to affiliate insured banks and the bank insurance fund.[436]

Likewise, the SEC acknowledged after the collapse of Drexel Burnham in 1990 that it "did not have adequate information regarding the Drexel holding company and its unregulated affiliates."[437] The lack of such information "severely hindered" the SEC's ability to evaluate the threat posed to Drexel Burnham's broker-dealer subsidiaries, including the "ability to know of the imminence of a liquidity crisis for the parent, and the corresponding risk that the broker-dealer's capital could be depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors."[438] In 2004, the SEC adopted a new consolidated supervisory approach, which applies on a voluntary basis to "supervised investment bank holding companies" (SIBHCs) that own securities broker-dealers.[439]

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[434] PACIFIC THRIFT MLR, *supra* note 334, at 5–6, 9–10, 17–20, 28–30; *see also* GAO-ILC REPORT, *supra* note 39, at 61 (discussing the involvement of PTL's holding company in PTL's failure).

[435] SOUTHERN PACIFIC MLR, *supra* note 334, at 6–10, 71–73.

[436] GAO-ILC REPORT, *supra* note 39, at 61–62 (reporting views of FRB officials).

[437] BROWN, *supra* note 315, at 25 (quoting testimony of SEC chairman Richard Breeden).

[438] *Id.*; *see supra* note 388 and accompanying text (discussing collapse of Drexel Burnham and the resulting failure of its broker-dealer subsidiaries).

[439] For discussions of the SEC's new consolidated supervisory approach for SIBHCs, see, for example, SCOTT, *supra* note 344, at 32–33, 166–67 (explaining that holding companies that own securities broker-dealers can "voluntarily register" as SIBHCs with the SEC in order to satisfy the requirements of the European Union's Conglomerates Directive); Jorge E. Viñuales, *The International Regulation of Financial Conglomerates: A Case-Study of Equivalence as an Approach to Financial Integration*, 37 CAL. W. INT'L L.J. 1, 3, 34–41 (2006) (describing the SEC's program of consolidated supervision for SIBHCs).

In February 2007, the FDIC expressed its concern that "the current supervisory process and infrastructure [for ILCs] may not produce the safeguards that the FDIC believes could be helpful" in evaluating and controlling the risks presented by ILC holding companies that are not subject to consolidated supervision by either the FRB or the OTS.[440] The FDIC therefore issued a proposed regulation, which would apply to any holding company that (i) is engaged solely in financial activities, (ii) proposes to acquire control of an ILC, and (iii) would not be subject to consolidated supervision by the FRB or the OTS. The FDIC's proposed regulation would require such a holding company to enter into a written agreement with the FDIC as a condition for acquiring control of the ILC. The agreement would require the parent holding company to (i) provide information and reports to the FDIC concerning the operations of itself and its nonbank subsidiaries, (ii) allow the FDIC to examine the holding company and each of its subsidiaries, and (iii) maintain the ILC's capital at specified levels.[441]

It is not entirely clear whether the FDIC has authority to force companies that acquire ILCs to enter into the consolidated supervision agreement described in the FDIC's proposed regulation.[442] However, the proposed regulation does make clear that the FDIC is no longer comfortable in providing deposit insurance to ILCs whose parent companies are not subject to consolidated supervision by a federal banking agency.

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

The problems arising out of acquisitions of ILCs by commercial firms cannot be solved simply by designating the FDIC as the consolidated supervisor of such firms. To the contrary, the creation of a federal consolidated regulator for commercial parent companies of ILCs would have at least four negative effects. First, the FDIC does not have any substantial experience or specialized expertise in evaluating the safety and soundness of commercial conglomerates. Naming the FDIC as consolidated supervisor for commercial parent companies of ILCs would greatly increase the FDIC's supervisory burden and would compel the

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[440] FDIC Moratorium Extension Notice, *supra* note 13, at 5293.

[441] FDIC Proposed Rule on Consolidated Supervision, *supra* note 43, at 5222–27.

[442] *Compare id.* at 5223 (contending that the FDIC possesses authority to adopt the proposed regulation), *with* GAO-ILC REPORT, *supra* note 39, at 45–46 (indicating some doubt whether the FDIC has authority to impose consolidated supervisory requirements on applicants who seek to acquire ILCs).

FDIC to hire new personnel with expertise in many different sectors of the U.S. economy.[443]

Second, designating the FDIC as consolidated regulator would have the undesirable effect of implying that the federal government is monitoring and assuring the overall solvency and stability of each commercial firm that owns an ILC. That implication might lead market participants to expect that the federal safety net would be extended to commercial parent companies of ILCs.[444]

Third, federal consolidated supervision of commercial owners of ILCs would greatly expand the scope of federal regulation within the commercial sector of our economy. From the 1950s through the 1990s, governmental authorities in Japan and South Korea played an extensive role in monitoring and directing the relationships between main banks and their commercial clients. Government regulators frequently pressured banks to provide credit to designated high-growth industries or to provide support for troubled commercial firms.[445] Giving the FDIC a similarly intrusive role in monitoring dealings between banks and their commercial affiliates could significantly interfere with the market-driven dynamics of the U.S. economy.[446]

Federal law currently requires the FDIC to oversee every transaction that results in a transfer of control of an ILC or its parent company. As shown by GM's recent sale of control of GMAC and its subsidiary ILC, the Change in Bank Control Act (CBCA)[447] requires the FDIC to review, and to decide whether to disapprove, any proposed change in control of a state nonmember bank.[448] The CBCA therefore provides a significant impediment to any hostile takeover of a parent company of an ILC.[449] Until recently, hostile takeovers rarely occurred in Japan and South Korea, due to the extensive ownership links between banks and commercial firms

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[443] *See, e.g.*, BROWN, *supra* note 315, at 4, 24–25, 42–45, 47; *Testimony before the Subcomm. on Telecommunications and Fin. of the H. Comm. on Energy and Commerce*, Apr. 11, 1991 (statement by E. Gerald Corrigan, President, Fed. Res. Bank of NY), *as reprinted in* 77 Fed. Res. Bull. 411, 418-19 (1991).

[444] Statement by E. Gerald Corrigan, *supra* note 443, at 418–20.

[445] *See* Aoki, Patrick & Sheard, *supra* note 342, at 27, 30–35, 45–47 (discussing the role of Japanese government officials in overseeing the relationships between main banks and commercial firms); Black et al., *supra* note 355, at 540–42, 551–52 (discussing the role of the South Korean government in overseeing the relationships between Korean banks and commercial firms); Milhaupt, *supra* note 355, at 206–08 (same).

[446] Statement by E. Gerald Corrigan, *supra* note 443, at 419.

[447] 12 U.S.C. § 1817(j) (2000).

[448] *See* MCCOY, *supra* note 51, § 10.02[1][a] (discussing the CBCA); *supra* notes 393–97 and accompanying text (discussing the FDIC's approval of GM's sale of control of GMAC);.

[449] *See* Wilmarth, *supra* note 212, at 291 (explaining that hostile takeovers of banks rarely occur in the United States, because "[r]egulatory approval requirements for bank mergers create significant obstacles to hostile takeovers").

and the government's heavy regulatory oversight of those relationships.[450] Hence, acquisitions of ILCs by commercial firms are likely to impair the effectiveness of market discipline over managers of the parent companies.

Fourth, major commercial firms that acquire ILCs are likely to use political influence to obtain subsidies or forbearance from regulators. Big commercial companies that own ILCs are likely to be not only TBTF but also "too big to discipline adequately" (TBTDA).[451] Major banks have proven to be TBTDA in the past. For example, during the banking crisis of 1984–1992, Bank of America and Citicorp, the two largest U.S. banks, each came perilously close to failure. However, federal regulators did not take public enforcement action against either bank or insist upon a replacement of its managers. Instead, regulators quietly entered into a nonpublic "memorandum of understanding," the weakest type of enforcement action, with each bank. Regulators evidently were unwilling to take strict enforcement measures against either bank because they feared that public disclosure of the bank's problems might "trigger[] a generalized crisis of [public] confidence" in the banking system.[452]

A further example of special regulatory treatment, as well as the extraordinary political influence that large financial conglomerates can wield, was the FRB's decision to approve the Citicorp-Travelers merger in 1998. That merger created an organization known as "Citigroup," which could not remain in operation under existing law for more than five years. Nevertheless, the FRB approved the transaction, based on the assumption (which proved to be correct) that Congress would remove the statutory barriers to the merger before the FRB's temporary exemption expired. One of the most striking aspects of the merger was that it received the advance blessing of President Clinton, Secretary of the Treasury Robert Rubin (whom Citigroup later hired as a co-chairman) and FRB chairman

[450] For discussions of traditional barriers to hostile takeovers in Japan, see, for example, Aoki, Patrick & Sheard, *supra* note 342, at 14, 30–31; Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 75–76, 81–85 (1995); Andrew Morse, *New Deal: Bank Fight to End, But Japan Won't Be the Same*, WALL ST. J., Aug. 17, 2004, at C1, *available at* LEXIS, News Library, WSJNL File (reporting that corporate takeovers in Japan rarely occurred before 1999). For discussions of traditional barriers to hostile takeovers in South Korea, see, for example, Black et al., *supra* note 355, at 551–52; Milhaupt, *supra* note 355, at 205–08; Laura Santini & Jason Singer, *Icahn's Push In Korea Shows Rise of Raiders Is Roiling New Markets*, WALL ST. J., Mar. 2, 2006, at A1, *available at* LEXIS, News Library, WSJNL File (describing the "first foreign-led hostile takeover attempt" against a major Korean firm, which "created a furor" within South Korea).

[451] TBTDA is a term coined by Professor Edward J. Kane. *See* Kane, *supra* note 264, at 669; Kane, *supra* note 292, at 673.

[452] Wilmarth, *supra* note 212, at 305.

Alan Greenspan, even before Citicorp and Travelers filed their application.[453]

The FDIC's decision in November 2006 to waive its initial moratorium on ILC applications, and to approve GM's sale of control of GMAC and its ILC subsidiary, is suggestive of the type of regulatory forbearance that is likely to be extended to large commercial owners of ILCs. The FDIC's decision was praised by a prominent member of Congress, but it was also criticized by a well-known bank analyst, who "accused the FDIC of bowing to congressional pressure and showing preferential treatment to certain companies."[454] The FDIC may well have adopted a "pragmatic approach" in removing an obstacle to a transaction that was viewed as "critical to the health of General Motors."[455] However, the FDIC's decision strongly indicates that major companies owning ILCs will receive special consideration from regulators if their financial stability is important to the national economy.

Even when regulators do try to take tough action against large troubled financial institutions, those institutions have often mobilized political influence to extract forbearance from the regulators. During the 1980s, federal regulators acted much more slowly in closing insolvent thrifts and banks if those institutions were larger in size or if they were located in congressional districts whose representative served on congressional committees having jurisdiction over bank regulatory policy.[456] Lincoln Savings used influence from five U.S. Senators to help delay its seizure by federal regulators for almost two years.[457] The Speaker of the House of Representatives and other members of Congress similarly intervened to delay the closure of large troubled thrifts in Texas and other states.[458]

In sum, further acquisitions of ILCs by large commercial firms are likely to introduce significant distortions in financial regulatory policy as well as the general economy. Given the demonstrated political power of

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[453] *Id.* at 220–21, 306–07; *see also* Kane, *supra* note 264, at 666 (stating that the Citicorp-Travelers merger "challenge[d] both the statutory letter and regulatory spirit of the [BHC] Act," and that both companies "boldly gambled that they [could] dragoon Congress and the regulatory community into legalizing their transformation into . . . Citigroup").

[454] Adler, *supra* note 397 (reporting on statements by Rep. Paul Gillmor and analyst Richard X. Bove); *see also supra* notes 393–97 and accompanying text (discussing FDIC's approval of GM's sale of control of GMAC).

[455] Adler, *supra* note 397 (quoting Rep. Gillmor).

[456] *See* Wilmarth, *supra* note 212, at 305–06, 306 n.373, 307 & n.379 and sources cited therein.

[457] *See* DAY, *supra* note 193, at 259–65, 338–48; LOWY, *supra* note 190, at 147–52, 218–21; MAYER, *supra* note 197, at 188–224.

[458] *See* DAY, *supra* note 193, at 230–58; LOWY, *supra* note 190, at 185–88, 193–94; MAYER, *supra* note 197, at 226–42.

financial conglomerates,[459] it seems highly undesirable to allow the creation of even larger combinations of financial and commercial interests.

IV. CONCLUSION

The FDIC made the right decision when it imposed a moratorium on further acquisitions of ILCs by commercial firms and urged Congress to consider the need for legislation barring such acquisitions. As shown above, commercially-owned ILCs contravene the policy of separating banking and commerce and also present significant risks to our financial system and our national economy. Commercial ownership of ILCs is likely to create serious distortions and competitive imbalances in our economy by (i) extending TBTF protection to large commercial owners of ILCs and (ii) encouraging ILCs to use their federally-subsidized, low-cost deposits to fund loans that will benefit their parent company's operations. Consolidated supervision of commercially-owned ILCs cannot control these risks and is likely to have additional negative effects. Consolidated supervision would increase the likelihood of TBTF bailouts, because FDIC supervision would create the appearance of implicit federal support for commercial owners of ILCs. In addition, consolidated supervision would require the FDIC to monitor and evaluate the operations of all commercial affiliates of ILCs, thereby producing an even more intrusive federal regulatory presence in the general economy.

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[459] *See* Wilmarth, *supra* note 212, at 307 (stating that the financial services industry spent an estimated $300 million on lobbying expenses and political contributions to obtain passage of GLBA). During the congressional debates on GLBA, some members of Congress warned of the dangers they saw in the political influence being wielded by financial conglomerates. *See* 145 CONG. REC. S13873–74 (daily ed., Nov. 4, 1999) (statements of Sen. Wellstone); *id.* at S13898 (statements of Sen. Feingold); 145 CONG. REC. H11541 (daily ed. Nov. 4, 1999) (statements of Rep. Hinchey).

Similarly, large financial institutions with credit card operations were the driving force behind enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which "radically altered the policies underlying consumer bankruptcy in this country, marking a significant shift in favor of creditors." Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 376; *see also id.* (noting that the law was passed "[a]fter extensive lobbying by banks and credit card companies"). Analysts and critics of the bankruptcy legislation maintained that political contributions and lobbying by major financial institutions played a key role in obtaining its passage. *See* Stephen Nunez & Howard Rosenthal, *Bankruptcy "Reform" in Congress: Creditors, Committees, Ideology, and Floor Voting in the Legislative Process*, 20 J. L. ECON. & ORG. 527, 533 (2004) (finding that "campaign contributions [were] significantly correlated with voting" and "[t]he impact of money was substantial" during Congress' consideration of a prior version of the legislation in 2001); *id.* at 534–35 (stating that financial service companies with credit card operations made almost $15 million of political contributions during the 2000 election cycle); Michele Heller, *Gauging the Bottom-Line Effects of Bankruptcy Bill*, AM. BANKER, Apr. 15, 2005, at 4, *available at* LEXIS, News Library, AMBNKR File (quoting statement by Rep. William Delahunt, during the final House debates on the law, asserting that "[t]he credit card industry bought and paid for this legislation. Somewhere north of $40 million was part of that effort").

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