Consumer Federation of America

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March 28, 2006

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS, Room 3060
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

RE: Application for Deposit Insurance for Wal-Mart Bank

Dear Mr. Feldman:

The Consumer Federation of America (CFA), a pro-consumer association of some three hundred non-profit organizations formed in 1968 to advance consumer interests through research, advocacy and education**,** urges the FDIC to reject the application of Wal-Mart Stores, Inc. to receive FDIC insurance for an industrial bank chartered in Utah. Enabling the largest retail firm in the world to purchase an industrial loan corporation (ILC) would represent a dangerous and unprecedented blending of banking and commerce. It would allow Wal-Mart to offer many of the same services and loans as commercial banks without the same rigorous regulatory oversight. (Although Wal-Mart has stated that does not intend to offer banking services or make loans, it could change its business plan once it is allowed to set up an ILC.) This has enormous negative implications for the safety and soundness of a Wal-Mart-owned bank and for taxpayers who backstop the deposit insurance system.

Wal-Mart's application violates long-standing principles of banking law that commerce and banking should not mix. Approving the Wal-Mart application would have long-standing impacts, as each ILC-commercial affiliation and entanglement makes it more difficult for Congress and regulators to renew the separation. Federal Reserve Chairman Ben Bernanke has noted that "widespread combinations of banking and commerce likely would be irreversible."[1]

Recent corporate scandals show the serious risks involved in allowing any commercial entity to own a bank without significant regulatory scrutiny at the holding company level. ILCs are effectively exempt from the Bank Holding Company Act (BHCA) which allows the Federal Reserve to conduct examinations of the safety and soundness not just of banks, but of the parent or holding company of these banks as well as their affiliates. The BHCA also grants the Federal Reserve the power to place capital requirements and impose sanctions on these holding

[1] Aversa, Jeanine, "Bernanke Questions Companies Owning Banks," *Associated Press*, March 21, 2006.

companies. The FDIC does not have these powers over ILCs.

Oversight of the holding company is the key to protecting the safety and soundness of the banking system. It is immaterial whether the owner of the bank is a financial or a commercial entity. Holding company regulation is essential to ensuring that financial weaknesses, conflicts of interest, malfeasance or incompetent leadership at the parent company will not endanger the taxpayer-insured deposits at the bank. Years of experience and bank failures have shown this to be true. For example, recent accounting scandals at Sunbeam, Enron, WorldCom, Tyco, Adelphia and many others involved deliberate deception about the financial health of the companies involved. If these companies had owned banks, not only would employees, investors and the economy have suffered, but depositors and taxpayers as well. The ILC charter is currently the only avenue available for commercial firms to become owners of taxpayer-insured depository institutions.[2]

The intermingling of commercial and banking business interests engenders at least two risks to the financial system and the economy. First, the mixing of banking and commercial operations may potentially have negative impacts on the safety and soundness of the bank itself. There would be no disincentive for the bank to help a troubled affiliated commercial enterprise, and that would potentially pose risks to the taxpayer-funded bank safety net and at least result in the expansion of the safety net to non-banking businesses. Moreover, the ILC regulatory exemptions to the Bank Holding Company Act exacerbate these safety and soundness risks. Since ILCs have grown significantly in size and scope, the risks of bank failure are increased. Second, the affiliation of bank and commercial firms creates a potential conflict of interest that could threaten the operation of the bank and distort the allocation of capital for other businesses.

The character of ILCs has changed significantly since they were introduced at the turn of the twentieth century to meet the credit needs of industrial workers. Former Federal Reserve Chairman Alan Greenspan stated in January 2006 that "The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption."[3] The commercial and non-financial ownership of ILCs is already excessive. Adding Wal-Mart to the ownership of ILCs further erodes the too permeable wall between commercial and depository institutions. Firms such as Merrill Lynch, American Express, GE Capital Financial, GMAC Commercial Mortgage Bank, BMW and Volkswagen own ILCs.[4] One fourth (24.5 percent) of the ILCs at the close of 2004 were held by non-financial holding companies or other firms that were not necessarily financial in nature (that had mixed commercial or manufacturing with their ILC operations).[5]

The FDIC has maintained that its current regulatory oversight regime is sufficient to manage the potential risks posed by ILCs affiliating with commercial firms, but changes in the size and scale of ILC operations suggest that the FDIC regulatory regime designed to monitor the smaller, stand-alone ILCs of the 1980s might be insufficient to monitor an ILC that was affiliated

[2] Government Accountability Office, "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621, September 2005 at 8.

[3] Aversa, Jeanine, "Greenspan Wants Banking Exemption Halted, *Associated Press*, January 26, 2006.

[4] GAO at 17.

[5] GAO at 66.

with one of the world's largest commercial entities. ILCs were never intended to be large, nationwide banks that offered services indistinguishable from commercial banks. In 1987, Congress granted an exception to the BHCA for ILCs because there were few of them, they were only sporadically chartered in a small number of states, they held very few assets and were limited in the lending and services they offered. Subsequently, ILCs began to "aggressively exploit" the regulatory loophole that allowed them to form partnerships, affiliations, mergers and subsidiaries with commercial entities.[6]

Prior to 1998, there were fewer than $20 billion in assets in all the ILCs combined.[7] According to the General Accounting Office (GAO), ILC assets grew by over 3,500 percent between 1987 and 2004, from $3.8 billion to over $140 billion. In 2004, six ILCs were among the 18 largest financial institutions in the country with $3 billion in assets.[8] According to the Federal Reserve, the majority of ILCs had less than $50 million in assets in 1987, with assets at the largest ILC at less than $400 million. As of 2003, one ILC owned by Merrill Lynch had more than $60 billion in assets (and more than $50 billion in federally insured deposits).[9] At the close of 2004, three of the top 16 largest federally insured institutions supervised by the FDIC were ILCs.[10]

The merger of commercial and ILC banking operations such as the proposed Wal-Mart application poses potential risks to the safety and soundness of the banking operation because there would be incentives for the bank to help shore up losses in the commercial operation and because the FDIC ILC regulatory limitations make it difficult to discern the potential risks of blending commercial and banking business entities. Moreover, allowing a Wal-Mart-owned industrial bank to enter the FDIC system would further widen the ILC loophole to the BHCA, which should be closed.

The ultimate risk of weakness in the safety and soundness of ILCs is the potential for bank failures which hurt depositors and taxpayers. This risk is increased as ILCs become larger. Moreover, the FDIC has not had to oversee the larger ILCs during periods of economic stress, as they have largely grown during the more prosperous, less risky post-S&L bailout era. Former FDIC Chairman Donald Powell has referred to the past decade as the "golden age" of banking.[11]

Federal banking rules generally allow regulators to examine the business of all affiliates, subsidiaries and holding companies of banks held in a bank holding company structure. ILC banks are effectively exempt from this regulatory oversight because they are not deemed to be "banks" under the Bank Holding Company Act. If ILCs have assets below $100 million *or* they do not offer demand deposit (traditional checking) accounts, they are not considered to be "banks" for the purposes of regulatory oversight.[12] This means that for all effective purposes, ILCs are exempt from the regulatory regimes that allow federal authorities to examine all affiliated

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[6] Olson, Mark, Federal Reserve Board Governor, Testimony Before the Senate Committee on Banking, Housing and Urban Affairs, June 21, 2005.

[7] GAO at 19.

[8] GAO at 5.

[9] Federal Reserve Board Letter to Representative James Leach, January 20, 2006 at 2.

[10] GAO at 11.

[11] GAO at 64.

[12] GAO at 17.

companies, subsidiaries and holding companies of the bank. Additionally, this non-"bank" designation allows ILCs to elude the prohibition against non-financial firms owning depository institutions.[13]

Although ILCs are subject to a range of federal banking regulations such as capital requirements, safety and soundness guidelines, consumer protection rules and the Community Reinvestment Act, the non-"bank" status of ILC holding companies limits the extent to which the FDIC can oversee the network of companies within the holding company. The Federal Reserve wrote in a letter to Representative Jim Leach that "The continued expansion or exploitation of the ILC exemption undermines the general policies that Congress has established concerning the mixing of banking and commerce, consolidated supervision of banking organizations operating in the United States, and the supervisory criteria applicable to diversified financial firms that seek to affiliate with an insured bank."[14]

The consolidated regulatory authority of the Federal Reserve to monitor bank holding companies and their affiliates and subsidiaries allows the regulator to monitor the books at all of the associated businesses to assess the impact the overall business structure and operation has or potentially has on the insured depository institution.[15] Consolidated supervision gives regulators the necessary tools to monitor and as necessary restrain holding company-wide activities that could threaten the depository institution.[16] In contrast, FDIC is only permitted to assess the extent to which affiliates have relationships with the banking entity, not to examine their operations for an overall picture of the holding company's business.[17]

Additionally, some of the tools available to enforce banking rules on bank holding companies are unavailable to the FDIC to use on wayward ILCs. The FDIC cannot prevent ILCs from entering into new activities if the ILC has a below satisfactory CRA rating and it cannot require the holding company to divest an under capitalized subsidiary to ensure the safety and soundness of the bank.[18] The ability to monitor the entire operation of a depository institution holding company is vital to ensure the safety and soundness of the depository entity because as the Federal Reserve has noted, "Financial trouble in one part of an organization can spread rapidly to other parts. To protect an insured bank that is part of a large organization, a supervisor needs to have the authority and tools to understand the risks that exist within the parent organization and its affiliates."[19]

The FDIC contends that it has working agreements with the ILCs that allow it to monitor the operations of the regulated entities, but these agreements or understandings are at the will of the regulated entities not at the authority of the FDIC. Essentially, this is voluntary compliance with FDIC oversight that could be terminated or obscured by the ILC holding companies as

[13] Dodd at 5.

[14] Federal Reserve Board Letter to Representative James Leach, January 20, 2006 at 4.

[15] GAO at 28.

[16] Federal Reserve Board Letter to Representative James Leach, January 20, 2006 at 5.

[17] GAO at 36.

[18] West, Mindy, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective," *FDIC Supervisory Insights*, Vol. 1, Iss. 1, Summer 2004 at 7.

[19] Olson, 2005.

desired without any regulatory implications. Although the FDIC has stated that it could suspend FDIC insurance for deposits, this is a ham-fisted and drastic approach that would create too much market instability for depositors and investors for FDIC to credibly act on this threatened regulatory sanction.[20]

Ultimately, the failure to ensure the safety and soundness of institutions as the result of ineffective or insufficient regulatory oversight could lead to bank failures. Generally, the risks to ILCs are similar to those of other insured depository institutions and arise from inappropriate business plans and models, incompetent management oversight, and poor implementation of adequate risk management policies.[21] There is concern that affiliated or parent companies could effectively shift business losses to the bank line of business by providing loans that it would not otherwise underwrite or investing in one of the affiliates, which effectively expands the insured depository institution safety net to other lines of commercial business.[22]

ILCs can and do fail. Between 1985 and 1999, 20 ILCs with assets of $600 million failed.[23] Since 2000, there has been only one ILC failure, but it was a significant failure. In 2003, the 18,804 depositor, $1.1 billion asset Torrance, California ILC, Southern Pacific Bank failed, costing taxpayers $63.4 million.[24] The failure was attributed to poor corporate governance, poor risk management, a misleading financial statement but also the "lack of consolidated supervision at the holding company level contributed to the problems that impacted the ILCs."[25] Although the 20 failed ILCs in the previous 15 years were insignificant in size and scope compared to failures in the thrift and bank industries at the same time, the Southern Pacific Bank was a large portion of all of the bank failures since 2000. In all, 28 banks with $5.4 billion in deposits failed since 2000, and Southern Pacific Bank's deposits of $865 million constituted about one in six (16.0 percent) of the failed deposit dollars.[26]

The combination of commercial and banking entities creates potential conflicts of interest for the bank's operations. Banks that are affiliated with commercial firms, especially non-financial firms, could risk putting the interests of the bank operation behind the interests of the affiliated commercial venture. This conflict of interest creates risks for depositors and the taxpayers that insure those deposits.

Banks that are affiliated with commercial firms face enormous pressures to help manage the commercial business' capital and risk allocation through transfers to or from the bank that creates inefficient allocation of credit resources.[27] Inter-company transactions between the bank and the commercial affiliates including the bank providing loans at favorable terms, the bank purchasing overpriced services from the affiliated commercial entity or requiring the bank to buy

[20] GAO at 44.

[21] FDIC Letter to Senator Robert Bennett, April 30, 2003.

[22] Blair, Christine E., "The Future of Banking in America, The Mixing of Banking and Commerce: Current Policy Issues," *FDIC Banking Review*, Vol. 16, No. 4, 2004 at 106.

[23] West at 12.

[24] FDIC *2003 Annual* Report at 120 and GAO at 61.

[25] GAO at 61.

[26] CFA calculation based on GAO and FDIC figures. *See* FDIC Bank Failures & Assistance webpage at www.fdic.gov/bank/historical/bank and Failed Bank List at www.fdic.gov/bank/individual/faiiled/banklist.html.

[27] Dodd at 6.

underperforming loans or other assets from an affiliate all could put the insured depository institution at risk.[28] Additionally, there is the possibility that the bank could require customers to purchase products or services from affiliates as a condition for extending credit known as tying.[29] The anti-tying rules in the Bank Holding Company Act govern banks, and the non-"bank" exemption that ILCs enjoy would prevent these provisions from being applied to these entities.

Moreover, the involvement of investment banking firms in recent corporate scandals has provided plenty of evidence of the need for rigorous scrutiny of these companies as they get more involved in the banking industry. In particular, the participation of some securities firms in the Enron and Wall Street analyst scandals has shown that these firms were rife with conflicts of interest that caused them to take actions that ultimately harmed their investors.

CFA strongly urges the FDIC to deny Wal-Mart's application. Moreover, we hope the FDIC will use the occasion of the Wal-Mart application to own an ILC to petition Congress to shut down this parallel banking system, not allow its further expansion.

Sincerely,

Travis B. Plunkett
Legislative Director

Patrick Woodall
Senior Researcher

[28] GAO at 13-14.
[29] FDIC Letter to Senator Robert Bennett, April 30, 2003.