Testimony before the Federal Deposit Insurance Corporation

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Thank you for inviting me to contribute to this public policy discussion – I consider it an honor.

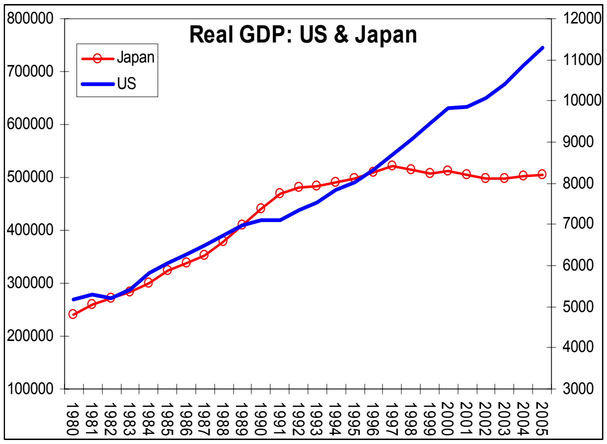
I think it is admirable that the FDIC is holding these public hearings. I know it is costly and not always satisfying to hear disagreement as well as discontent. We should take solace in the strong interest shown by the public in this financial policy matter. I certainly welcome that. It is the first government hearing on financial policy that I can remember when the number of citizens and non-profits is substantially larger than that of trade associations and lobbyists.

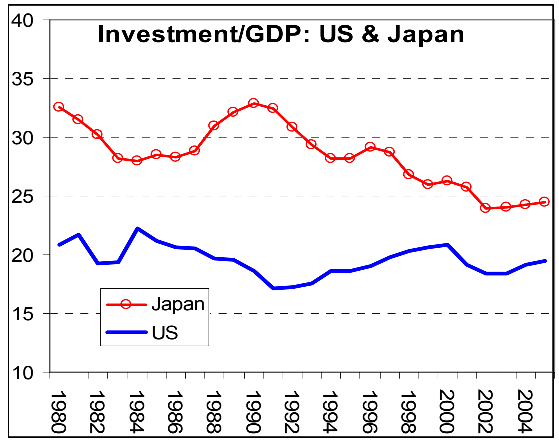
Although this concluding session of the hearing follows hours of testimony and discussion, let me assure you that I nonetheless intend to add value to the discussion.

Let me address two fundamental questions before the FDIC (agency). One is whether the current regulatory treatment of industrial loan banks (ILB) is good policy or whether it is a bad loophole in what is otherwise good, prudential regulation. The other is whether extending an ILB charter to Wal-Mart amounts to a significant expansion of that policy.

If we get past the awkward name – industrial loan company – and focus on the role these institutions play in our economy, then we see that they are in all but name a bank. (In my report submitted to the agency I suggest we refer to them as industrial loan banks – they have nearly all authorities granted to banks and Utah state law allows them to use the name 'bank' in their business title.) These banks are currently the only way that a commercial or industrial corporation can own and operate a bank. It is thus the only ongoing exception or loophole to an important pillar of prudential banking regulation in the United States – the separation of ownership and control of banking from commercial and industrial enterprises. Congress reaffirmed that separation in the Financial Modernization Act of 1999.

The separation of ownership has been a pillar of financial stability in this country and a disaster when the principal was violated during the 1920s and early 1930s. In contrast to the United States, Japan still has not learned that lesson and its economy lost a decade of growth and suffered subpar rates of investment. The following charts show the consequences of a crippled banking sector on real growth and investment starting in 1990.





The rationale for the separation of banking and commerce is based on solid economic reasoning, and it has produced a safe, sound and efficient financial system in the United States since the Glass-Steagall Act of 1933.

There are several economic dangers from mixing ownership and control. One is for the bank to become too exposed through loans to its parent holding company, affiliates, management as well as its clients, vendors and customers. Although federal banking laws set limits on such loans and financial transactions, the lack of consolidated holding company supervision raises fears of ineffective enforcement. Through this linkage, trouble in the commercial business would harm the bank and hamper the ability of the bank to lend. We have already seen troubled firms failing to adequately maintain their pension funds. Similarly troubled firms might short change their banking subsidiaries. While Wal-Mart appears bulletproof today, much like GM appeared bulletproof not so many years ago, the future is uncertain and the best protection against that uncertainty is consistent application of prudential regulatory standards.

Taken on a macroeconomic level, this linkage would mean that an economic recession would harm banks' ability to lend, thereby hampering their ability to finance any expansion in activity that would be required to spur the economy into recovery and prosperity.

Another danger is that the parent company or its affiliates could drain the bank of its capital or steer the bank towards reckless lending in the promotion of the parent's own interests. The second largest failure of an industrial loan bank – the Pacific Thrift and Loan – was caused by just such mismanagement by the parent company. These conflicts of interest should always be avoided, but they pose the greatest danger when they arise at banks and other financial institutions that serve as the core of our economy's payments and clearing system – and an industrial loan bank charter provides direct access to the Fedwire, the Fed's payments systems and the automated clearing house.

What is more, the safety and soundness problems posed by cross-ownership and control of banking and commercial firms are all the greater in this case because the Competitive Equality in Banking Act of 1987 exempts industrial loan banks from consolidated supervision and regulation under the Banking Holding Company Act. Cross-ownership would not only expose our economy to various economic dangers, it would do so without the prudential regulatory framework that applies to other banks – namely consolidated supervision and regulation of the whole enterprise. In today's world of large and complex corporations, the only hope of prudential regulation is with consolidated regulation and supervision. Disregarding this wisdom is a reckless policy at a time when the nation's need to attract ever increasing amounts of foreign capital depends crucially on the perceived safety and soundness of our financial system.

The loophole in prudential bank supervision and regulation created by industrial loan banks is a bad policy for the U.S. economy. It threatens the safety and soundness of our financial system and further undermines its economic efficiency by creating an uneven playing field of competition.

Expanding the scale of this policy by allowing the creation of a Wal-Mart bank with government insured deposits is a giant step in the wrong direction. Just because policy mistakes have been previously made in granting such charters and deposit insurance to GM and Toyota, it does not justify making an even bigger policy mistake by expanding the scale of the loophole – a regulatory loophole the size of a Wal-Mart.

In conclusion, let me state first what it is not…

- It is not about lowering the cost of banking services. Wal-Mart does not even claim to be trying to lower ATM fees and the price of other consumer banking services. They say they want to raise funds cheaply and have direct access to the nation's Fed wire and automated clearing house. Besides, the US banking sector already includes nearly 9,000 banks and another 9,000 credit unions – why should one more bank change the competitiveness of the market.
- If lowering consumer costs were the goal, Wal-Mart could contract with existing financial institution to provide these services to its customers at lower costs – after all Wal-Mart is famous for driving down the prices paid to its suppliers and vendors.
- It is not about fairness to Wal-Mart. It is about unfairness to competing financial institutions that are – and should be – subject to holding company oversight.
- The issue is not about Wal-Mart *per se*. Their controversial public image just brings these issues to the fore. The agency's decision need not be viewed as arbitrarily or capriciously reflecting any such prejudice.

What it does mean, and what it is about, is whether the safety, soundness and efficiency of the U.S. financial system is best preserved by granting deposit insurance for a bank chartered by a commercial or industrial holding company that would lack the normal prudential oversight of consolidated regulation.

Industrial loan banks are an unproductive and unnecessary loophole in the country's regulatory framework of financial institutions. As such, there is no economic rationale for expanding the loophole, and a larger expansion would be a worse policy than a smaller expansion. A firm the size of Wal-Mart would certainly amount to a large expansion. And this is all the more important given Congressional consideration of new laws that would expand the authority of industrial loan banks to offer additional types of checking accounts and to expand interstate by opening new or "*de novo*" branches – effectively expanding the scope of the loophole. Extending another charter, especially to such a major commercial behemoth as Wal-Mart, would expand the scale of the loophole and amount to a taking major step in the wrong direction.