Opinion

Mixing Banking and Commerce

BY JOHN R. WALTER

Many U.S. firms include both commercial and nonbank financial units. For example, Ford Motor Co. encompasses not only units that manufacture automobiles but also those, such as Ford Motor Credit, that gather funding and make loans to individuals. Firms that handle both commercial and financial activities appear to reap significant benefits which create the appeal of such combinations. One byproduct of a commercial firm's activities may be information about its customers' financial situation. The financial affiliate might then use this information to inexpensively target products to particular customers, benefiting both the financial firm and its customers, an activity commonly know as cross-selling.

While finance-commerce combinations are widespread, combinations between banks and commercial firms typically are prohibited. But the law does provide a loophole that allows nonfinancial firms to engage in a limited range of banking activities. It is through this well-traveled loophole that retail giants Wal-Mart and Home Depot recently have submitted applications to form or buy banks.

These applications have focused a great deal of attention on the controversial combination of banking and commerce. The merits of the specific Wal-Mart and Home Depot applications aside, this may be a good time to ask why banking-commerce combinations are typically prohibited in the first place.

The Bank Holding Company Act of 1956 prohibits commercial firms from owning banks. This keeps manufacturers and operators of retail stores, for example, from purchasing banks. The Gramm-Leach-Bliley Act, enacted in 1999, opened the opportunity for banks to be owned by companies engaged in the financial activities of securities dealing and insurance, but did not allow bank ownership to nonfinancial commercial firms.

The Bank Holding Company Act, however, does allow commercial companies to own industrial loan corporations (ILCs), or industrial banks. These institutions are funded with Federal Deposit Insurance Corp.-insured deposits but typically do not offer checking accounts to businesses. (Wal-Mart wants to create an industrial bank and Home Depot wants to buy one.)

According to a Government Accountability Office study, there were 57 industrial banks at the end of 2004. They held $140 billion in assets, and about 3 percent of all insured bank deposits. While many are owned by financial firms, a number are owned by commercial firms such as the automotive company BMW and retailer Target Corporation.

Why are banking-commerce combinations controversial? Observers have at times raised concerns over conflicts of interest that might arise if banks and commercial companies are owned by the same firm. They argue that such concerns justify keeping banking and commerce separate. While this argument takes several forms, the most frequent is that a bank affiliated with a commercial firm would tend to deny loans to the affiliate's competitors. Under this scenario, a bank with a commercial affiliate — say, a restaurant — would not wish to provide funding to competing restaurants. Helping the competitor would tend to lower the profits of the affiliated restaurant.

On the other hand, if competition is reasonably strong — and there is every reason to think that today's banking markets are quite competitive — denying loans to competitors only lowers overall profits of the consolidated banking-restaurant firm. If there are alternative lenders over which the affiliated bank has no price advantage, the competing restaurant would receive a loan regardless at the same interest rate the affiliated bank would offer. So, by failing to make the loan, the bank loses any profit it might have made on that loan, hurting the bank. And the affiliated restaurant gains no advantage.

Consequently, concerns regarding conflicts of interest are probably insufficient justification for maintaining the current wall separating banking and commerce and denying firms the opportunity to benefit from combinations. Nevertheless, there remains a hazard that could justify the continued presence of the wall, or at least require that significant precautions be taken if the wall is removed.

The hazard is that a combined company can be expected under certain circumstances to withdraw resources from its bank to hide problems in its commercial subsidiary, damaging bank safety. A holding company owning a bank and a commercial entity can be expected to choose this course when it can hide its commercial subsidiary losses from investors and analysts by shifting commercial subsidiary losses to the affiliated bank. Since bank assets are often considered more opaque to outsiders than nonbank assets, such losses might be better hidden if shifted to the bank. If commercial firm losses can be expected to be shifted to insured banks, and perhaps on to the FDIC, there may be reason to prevent combinations.

Potential loss-shifting presents real risks to the public. Stepped-up oversight could potentially mitigate those risks and, as a result, allow us to remove the wall between banking and commerce. For now, though, combinations through the industrial bank loophole raise legitimate concerns for bank regulators, and deserve careful consideration before being approved. **RF**

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