Reconsidering the Separation of Banking and Commerce

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ABSTRACT

This Article examines the long-held belief that banking and commerce need to be kept separate to ensure a stable banking system. Specifically, the Article criticizes the Bank Holding Company Act ("BHCA"), which prohibits nonbanking entities from owning banks. The recent banking collapse has caused and exacerbated several problematic trends in U.S. banking, especially the conglomeration of banking entities and the homogenization of assets. The inflexible and outdated provisions of the BHCA are a major cause of these trends. Since the enactment of the BHCA, the landscape of U.S. banking has changed dramatically, but the strict separation of banking and commerce embodied in the BHCA does not reflect these changes. This Article argues that allowing commercial firms to own banks could lead to a more diversified and less risk-prone financial structure, and gives examples of possible changes and potential ownership structures that could reduce risks in the financial system.

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INTRODUCTION

In 2005, during the heyday of banking, Wal-Mart Stores, Inc., petitioned the Federal Deposit Insurance Corporation ("FDIC") to open a bank.[1] The controversy that followed was monumental—experts and the public were outraged and voiced their fears about a potential Wal-Mart national bank.[2] Many feared that a Wal-Mart bank would threaten bank safety and pose an unacceptable threat to community banks across the country that would ultimately result in their failure.[3]

Although it is likely that a Wal-Mart bank would have posed a formidable challenge to small banks across the country, it is also probable that if Wal-Mart had opened a bank in 2005, its bank today would

1 Application for Deposit Insurance for Wal-Mart Bank, 71 Fed. Reg. 10,531, 10,532 (Mar. 1, 2006) (public hearing notice).

2 Eric Dash, *Wal-Mart Abandons Bank Plans*, N.Y. TIMES, Mar. 17, 2007, at C1.

3 *Id.*

be one of the safest in the country. In contrast to small and large traditional banks that failed by the hundreds, a bank backed by the retail behemoth would most likely have thrived. A Wal-Mart bank would have a natural financial incentive to limit risk. If the bank had failed like so many banks across the country, Wal-Mart would have had to pay out its obligations.[4] The specter of real loss diminishes incentives for risktaking even without regulation. By contrast, the current banking structure perversely incentivizes banks to increase leverage and risk exposure. When risktaking causes banks to default or fail, the federal government subsidizes losses explicitly through deposit insurance, and implicitly through bailouts.[5] These are important seeds of the banking crisis: banks make increased profits when they take increased risks but do not bear the full burden of the downside of that risk.

Since the crisis, banking regulators have been patching up holes in the regulatory dam that stands tenuously to prevent the flow of money from regulated banks into high-risk ventures promising significant returns on investments. What they have not done is examine the dam itself and ask whether the way banks are structured and owned has created hazardous incentives. In other words, in attempting to remedy the problem with measures such as the Dodd-Frank Wall Street Reform and Consumer Protection Act,[6] regulators have focused their efforts on making and amending lists of what banks can and cannot do without paying attention to the underlying structures that motivate banks to skirt the rules.

When banks are incentivized to take risks, even the most targeted and comprehensive regulation comes up short. Regulating the banking industry is enormously complex. It is too easy for regulators to be lulled into complacency by a smooth economy and too difficult to see the dangers lurking beneath the surface of enormous banking organizations.[7] Indeed, some have argued that regulators had the power to prevent the most recent banking crisis, but that they did not do so

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4 *See infra* Part II.C.2.

5 Collectively these are referred to as the "banking safety net." *See* ANDREW G HALDANE & PIERGIORGIO ALESSANDRI, BANKING ON THE STATE 2–4 (2009), *available at* http://www.bis.org/review/r091111e.pdf (describing the historical evolution of the banking safety net).

6 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of 12 U.S.C.).

7 *See* Gretchen Morgenson, *A Bank Crisis Whodunit, With Laughs and Tears*, N.Y. TIMES, Jan. 30, 2011 (SundayBusiness), at 1 (discussing the recent report issued by the Financial Crisis Inquiry Commission and noting that the Federal Reserve, despite the financial crisis all around it, remained "defiantly inert and uninterested in reining in the mortgage mania" and continued its cozy relationships with large financial institutions).

because they did not recognize the problem as such.[8] Unfortunately, given the complexity of the current system, it seems unlikely that Dodd-Frank will miraculously fix this regulatory blindness.

Thus, the solution to the problem does not lie in tweaking the details of the labyrinthine regulatory scheme, but in examining the roots of the underlying problems in banking. This Article examines and challenges one of the guiding principles of banking regulation: the separation of banking and commerce, as enforced through the Bank Holding Company Act ("BHCA").[9] For decades, banking law has been guided by an unchallenged principle that banking and commerce should not mix.[10] The principle's torchbearers have claimed that its enforcement is necessary to ensure the safety of the banking system,[11] when in fact it has led to a banking system more prone to collapse. This Article suggests that the walls erected in the name of safety have intensified the crisis noted above.

The concept of separating banking from commerce has also been muddled in the policy and academic discourse in the past several decades. Scholars and policymakers have erroneously considered the separation of banking and commerce to be a single concept, when in fact it is two very different subconcepts. This Article attempts to dispel that confusion by distinguishing what is referred to as the separation of banking and commerce *in banking*, which addresses what a bank can do, from the separation of banking and commerce *in commerce*, which addresses who can own a bank. This distinction leads to a clearer discussion of what is at stake in bank regulation.

Part I of this Article defines separation of banking and commerce, and describes and differentiates the various meanings inherent in the term; it also briefly discusses the history associated with the different variations of the principle. Part II describes how separating banking and commerce through the BHCA has caused and exacer-

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8 *See, e.g.*, *Subprime Lending and Securitization and Government Sponsored Enterprises: Hearing Before the Fin. Crisis Inquiry Comm'n* 10 (2010) (written statement of Alan Greenspan, former Chairman, Board of Governors of the Federal Reserve System), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-04-07%20Alan%20Greenspan%20Written%20Testimony.pdf ("I believe that during the past 18 months, there were very few instances of serial default and contagion that could not have been contained by adequate risk-based capital and liquidity.").

9 Bank Holding Company Act, 12 U.S.C. §§ 1841–1843 (2006).

10 Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of Principal Issues*, FIN. MARKETS INSTITUTIONS & INSTRUMENTS, Aug. 1999, at 1, 1. For an in-depth discussion of the history of the separation of banking and commerce in the United States, including policy issues and cost-benefit analyses, see *id.* at 7–14, 20–44.

11 *Id.* at 21.

bated the precarious structure of modern banking. Finally, Part III outlines possible alternatives to the strict separation of banking and commerce, such as commercial ownership of traditional banks, and analyzes potential benefits and problems in such arrangements. Specifically, this Article demonstrates the advantages of commercial ownership of banks by analyzing data from industrial banks, which are the only bank charters exempt from the BHCA's restrictions on commercial ownership.

I. Separation of Banking and Commerce

The concept of separation of banking and commerce has been discussed for almost a century, but has taken on different meanings during that time.[12] Without a coherent definition of what this separation is meant to achieve, policymakers have used the broad umbrella of "separation of banking and commerce" to justify various contrasting measures. If there has been any consensus on this overbroad phrase, it has been that the mixing of banking and commerce is risky.[13] Indeed, even without convincing evidence of its ill effects, the idea that banking and commerce must be kept separate has resurfaced during attempts at banking reform in the immediate aftermath of various financial crises.[14] It is often argued that banks are particularly vulnerable entities that need heightened restrictions and regulations to protect them,[15] and that any mingling with commercial firms or

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12 *See* Christine E. Blair, *The Mixing of Banking and Commerce: Current Policy Issues*, 16 FDIC Banking Rev., no. 4, 2004 at 97, 99, *available at* http://www.fdic.gov/bank/analytical/banking/2005jan/article3.pdf ("The literature on the issue of a long-standing principle of separating banking and commerce is extensive.").

13 Pauline B. Heller & Melanie L. Fein, Federal Bank Holding Company Law § 17.01[6], at 17-8 (rev. ed., release 27, 2011) (discussing congressional testimony in the 1940s and 1950s, in which several Federal Reserve chairmen warned of the risks associated with mixing banking and commerce).

14 *See* Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 Conn. L. Rev. 1539, 1564 (2007) [hereinafter Wilmarth, *Wal-Mart*] (noting that Congress pointed to banks' speculative securities and real estate operations as important causes of the collapse of the banking system in the early 1930s to justify more stringent separation legislation); *id.* at 1573–79 ("Congress responded to the thrift debacle by enacting the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). . . . [S]everal provisions of FIRREA strictly limited the authority of thrift institutions to engage in commercial lines of businesses or to be associated with commercial firms."); *see also* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 Conn. L. Rev. 963, 970–72 (2009) [hereinafter Wilmarth, *Dark Side of Universal Banking*] (arguing that large financial conglomerates offering a variety of nontraditional fee-based services helped precipitate the recent financial crisis).

15 *Bank Holding Bill: Hearings on S. 2318 Before a Subcomm. of the S. Comm. on Banking and Currency*, 81st Cong. 216 (1950) (statement of Thomas McCabe, Chairman, Board of Gover-

commercial activities would corrupt them.[16] This assertion has not yet been convincingly studied.

A. *Different Meanings of "Separation of Banking and Commerce"*

Although there are a number of possible ways that banking and commerce can mix, the most common are (1) banks engaging in nonbanking activity, and (2) commercial firms owning banks.[17] This Article differentiates these two concepts as "the separation of banking and commerce *in banking*," which deals with banks engaging in commercial activities, and "the separation of banking and commerce *in commerce*," which addresses commercial ownership of banks.

Most commentators and industry experts refer to the separation of banking and commerce without making any distinction between the different variations of this concept.[18] However, the forms are quite distinct and incomparable. This oversight has led to a muddled discourse on the topic with abuses associated with banks engaging in nonbanking activity being cited as justifications to prohibit commercial ownership of banks.[19]

Even those scholars who have written about the separation of banking and commerce have neglected to clearly distinguish the two forms of separation.[20] When Professor Edward Symons wrote about the need for separating banking and commerce, he used historical

nors of the Federal Reserve System) ("[O]f this fundamental truth I have become convinced: That the business of banking is a sacred public trust."). *See generally* E. Gerald Corrigan, *Are Banks Special?*, 1982 FED. RES. BANK MINNEAPOLIS ANN. REP. 2, *available at* http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm (discussing the factors that distinguish financial institutions from all other institutions and how those differences should shape the way banks are regulated).

16 The abuses cited are, among others, conflicts of interest, concentration of power, and systemic risk concerns. Wilmarth, *Wal-Mart*, *supra* note 14, at 1568–69 (citing S. REP. NO. 91-1084, at 3 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5519, 5522; H.R. REP. NO. 91-1747, at 1–2 (1970) (Conf. Rep.)).

17 *See* Joseph G. Haubrich & João A. C. Santos, *Alternative Forms of Mixing Banking with Commerce: Evidence from American History*, 12 FIN. MARKETS INSTITUTIONS & INSTRUMENTS 121, 122–23 (2003) (showing that there are at least five different examples of how banking and commerce can be combined: "(1) a bank owns a firm; (2) a bank controls a firm; (3) a firm owns (or controls) a bank; (4) a person controls both a bank and a firm; and (5) a holding company controls both a bank and a firm").

18 *See, e.g.*, John Krainer, *The Separation of Banking and Commerce*, 2000 FRBSF ECON. REV. 15, *available at* http://www.frbsf.org/econrsrch/econrev/2000/article2.pdf (discussing the costs and benefits of a union between banks and commercial firms, without defining exactly what that union would entail).

19 *See infra* Part I.A.2.

20 *See, e.g.*, Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481 (1988). Professor Halpert advocates for a mixing of banking and commerce,

data that related to banks engaging in commercial activities to justify a sweeping reproach of the mixing of banking and commerce, but never addressed any dangers associated with commercial ownership of banks.[21] In addition, when Professor Arthur Wilmarth argued that commercial firms should not be allowed to own banks, he relied in part on "several occasions" when "failures of depository institutions involved with commercial activities triggered serious financial crises."[22] The difference in the two types of separation, however, is crucial. They involve different risk incentives and structures, and any discussion of separating banking and commerce must distinguish between these two meanings.

The mixing of banking and commerce *in banking*, discussed below, has received much attention in the last several years and has been cited as one of the causes of the recent financial crisis.[23] The separation was imposed by the Glass-Steagall Act[24] in 1933, undone by the Gramm-Leach-Bliley Act[25] in 1999, and reapplied by the Dodd-Frank Act through the Volcker Rule.[26] Most of the academic and regulatory

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and although his history takes into account the BHCA, his examples and analysis do not deal with commercial bank ownership, but rather activities conducted within a bank. *Id.*

21 *See generally* Edward L. Symons, Jr., *The "Business of Banking" in Historical Perspective*, 51 GEO. WASH. L. REV. 676, 723–26 (1983).

22 Wilmarth, *Wal-Mart*, *supra* note 14, at 1554.

23 *See, e.g.*, Wilmarth, *Dark Side of Universal Banking*, *supra* note 14, at 972.

24 Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

25 Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §§ 101, 103, 113 Stat. 1338, 1341–1351 (1999) (codified as amended at 12 U.S.C. §§ 377, 1843 (2006)).

26 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (to be codified in scattered sections of 12 U.S.C.). After the stock market crash of 1929 and the banking crisis that ensued, contemporary observers believed, much like current commentators, that the mixing of banking and commerce contributed to the crash and the Great Depression. *See* Randall S. Kroszner & Raghuram G. Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933*, 84 AM. ECON. REV. 810 (1994). In response, Congress passed Glass-Steagall, which prohibited, inter alia, "commercial banks from underwriting, holding, or dealing in corporate securities, either directly or through security affiliates." *Id.* at 810 (citing the Glass-Steagall Act). This mandatory separation continued until the 1980s when the Federal Reserve Board permitted banks to own subsidiaries that engaged in securities dealing and underwriting. Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. CIN. L. REV. 943, 960 (2007). Subsequently, as a result of lobbying and the trend established by the Federal Reserve, Congress passed Gramm-Leach-Bliley, which limited Glass-Steagall and provided, inter alia, that entities qualifying as "financial holding companies" can engage in underwriting, holding, or dealing with corporate securities. *Id.* However, following the financial crisis of 2007 and 2008, Congress passed Dodd-Frank, which created a regulatory framework that effectively dismantled Gramm-Leach-Bliley and reinstituted many of the same principles of Glass-Steagall. *See* DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 4–6 (2011). Specifically, Dodd-Frank, through the

debate for the last several decades has focused on this separation. Regulating the separation of banking and commerce *in banking*, however, merely tinkers with the regulatory regime without changing the incentive structure of the banking system, and thus does not address the problematic incentive structures within banks.

Accordingly, although this Article briefly details the inception of these two separations of banking and commerce, it focuses on the separation of banking and commerce *in commerce*—specifically, bank ownership by commercial firms. The restrictions on bank ownership are especially relevant today due to the drastic changes in banking caused by the recent crisis.

1. The Separation of Banking and Commerce in Banking

It seems settled from historical experimentation that when banks engage in commercial activities, there is instability and loss. In his seminal article, *The "Business of Banking" in Historical Perspective*, Symons argued that since the early Republic, banking regulators or their historical equivalents have attempted to stop banks from engaging in nonbanking businesses because they saw banks losing their depositors' money when the banks would engage in commercial activity.[27] Policymakers wanted banks to be a safe place for deposits and asserted that banks engaging in commerce compromised public trust in the institution. Therefore, predating the New Deal and the regulatory fervor that opened the doors for Glass-Steagall, the National Bank Act and various other regulatory measures were designed to separate banking and commerce in banking.[28]

The term "separation of banking and commerce" was first used to justify Glass-Steagall, which initiated a prohibition on banks engaging in "nonbanking" activities, such as securities or insurance underwriting.[29] Before the stock market crash of 1929, banks had grown in size, moving away from the small, localized system of early American banking.[30] Glass-Steagall was a response to the general public sentiment that the Great Depression was caused by alliances between

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Volcker Rule, *see infra* notes 36–41, restricts banks' proprietary security activities and sponsorship of private-equity firms, Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, 124 Stat. at 1620–31; SKEEL, *supra*, at 85–91.

27 Symons, *supra* note 21, at 685.

28 *See generally id.* (discussing the phrase "the business of banking" and the ways in which the term has been defined to restrict bank powers since it was first used in the 1863 predecessor to the National Bank Act).

29 Krainer, *supra* note 18, at 16–17.

30 Carl Felsenfeld, *The Bank Holding Company Act: Has It Lived Its Life?*, 38 VILL. L.

bankers and industrialists, which led to unfair and risky practices that brought down banks, commercial firms, and the U.S. economy.[31] This analysis was not complete, but it was accepted by the public as an explanation for the Great Depression.[32]

Glass-Steagall focused on the activities that could be conducted within a bank and was the first legislative attempt to explicitly separate commerce-like activities from traditional banking activities inside a banking structure.[33] Specifically, Glass-Steagall restricted banks from engaging in investment banking and commercial banking activities and set restrictions on banks underwriting securities or insurance and engaging in other types of brokerage services.[34] These restrictions remained in effect until 1999 when Gramm-Leach-Bliley repealed many of the important restrictions and firewalls imposed by Glass-Steagall.[35] Specifically, Gramm-Leach-Bliley repealed the provisions of Glass-Steagall that forbade banks from engaging in securities and insurance underwriting with the purpose of making banks more competitive in response to appeals by the banking industry for deregulation.[36]

Recently, the Volcker Rule, which became part of the financial reform package passed by Congress in July 2010, reinstated these same restrictions.[37] It was widely believed that proprietary trading

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REV. 1, 6–10 (1993) (discussing the evolution of bank size from the time of the American Revolution through the early 1900s).

31 WILLIAM D. JACKSON, CONG. RESEARCH SERV., IB 87061, GLASS-STEAGALL ACT: COMMERCIAL VS. INVESTMENT BANKING 2 (1987) ("In the nineteenth and early twentieth centuries, bankers and brokers were sometimes indistinguishable. Then, in the Great Depression after 1929, Congress examined the mixing of the 'commercial' and 'investment' banking industries that occurred in the 1920s. Hearings revealed conflicts of interest and fraud in some banking institutions' securities activities. A formidable barrier to the mixing of these activities was then set up by the Glass-Steagall Act."); Felsenfeld, *supra* note 30, at 63 ("The Act was a congressional reaction to the Great Depression and the high-flying securities speculations engaged in by some banks and their affiliates during the 1920s that Congress considered partly responsible for the economic crisis.").

32 Some have rejected the idea that the Great Depression was caused by relationships between bankers and industrialists. *See, e.g.*, OFFICE OF RESEARCH & STRATEGIC PLANNING, FED. DEPOSIT INS. CORP., MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY 37–38, 42 (1987).

33 *See* Blair, *supra* note 12, at 100.

34 Wilmarth, *Wal-Mart*, *supra* note 14, at 1564–65.

35 Many commentators believe that the deregulation of banking caused by Gramm-Leach-Bliley is one of the main causes of the current financial crisis. For a discussion of this argument, see Wilmarth, *Dark Side of Universal Banking*, *supra* note 14, at 973, 987, 1049–50.

36 Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §§ 101, 103, 113 Stat. 1338, 1341–51 (1999) (codified as amended at 12 U.S.C. §§ 377, 1843 (2006)).

37 *See generally* John Cassidy, *The Volcker Rule: Obama's Economic Advisor and His Battles over the Financial-Reform Bill*, NEW YORKER, July 26, 2010, at 25.

within banks had led to banks engaging in riskier behavior, and that, by prohibiting proprietary trading, regulators could cause banks to focus on less risk-prone practices.[38] Paul Volcker, a former chairman of the Federal Reserve, argued that commercial banks, which are supported by the FDIC insurance fund, should focus on less risky, traditional banking practices, such as lending and deposit taking.[39] Investment banks, on the other hand, which are not supported by the FDIC, can focus on proprietary trading, or speculating in the markets for their own gains.[40] The rule thus relieves the taxpayer from providing a backstop for these risky activities.

The regulation of the activities banks may conduct will likely decrease some opportunities for risktaking in the financial sector, but it will not address the incentives guiding banks to engage in those risks. By Paul Volcker's own admission, it is unlikely that this rule (as adopted in the final version of Dodd-Frank) will cause banks to incur less risk.[41] Banks may be forced to change their practices, but if they want to engage in risky activities, they can. It is difficult to regulate away risktaking behavior, because the regulated entity that stands to gain a large profit will likely be able to find a loophole to skirt the defined limits. What is needed instead are changes to the fundamental structure of banks that will discourage excessive risktaking activity. One such possible change—allowing commercial entities to own banks—has historically been forbidden based on the same rationale used to justify the separation of banking and commerce *in banking* as discussed above.

2. *The Separation of Banking and Commerce in Commerce*

In 1956, the BHCA initiated the prohibition on commercial firms owning banks, or the separation of banking and commerce in commerce.[42] Notably, the BHCA was a reaction to a perceived threat that had not yet materialized.[43] The threat was conglomeration in banking, and the perpetrator was Transamerica, a large corporation that controlled interests in a variety of different industries, including a few

38 *Id.* at 25–26.

39 *Id.* at 25.

40 *Id.*

41 *See id.* at 26.

42 Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841–1843 (2006); Blair, *supra* note 12, at 100.

43 *See* Office of Research & Strategic Planning, *supra* note 32, at 31; *see also* Blair, *supra* note 12, at 100.

banking subsidiaries.[44] The BHCA was enacted to stop the feared expansion of Transamerica into a national banking conglomerate.[45] The Federal Reserve Board feared Transamerica's "commingling of banking and commerce" because it controlled the largest bank in the world, Bank of America, in addition to forty-six other banks and numerous nonbank interests.[46] After a failed attempt to combat the expansion with antitrust laws,[47] Congress passed the BHCA.[48]

The BHCA and its amendments were created mainly as preventative measures, backed by speculation that banks might be jeopardized by commercial firms or that bank ownership would become monopolistic.[49] The BHCA was not created to react to a history of abuse, and no abuse was cited to justify its enactment.[50] In the congressional hearings, there was no testimony that the bank holding company legislation "was for the purpose of correcting any present or existing difficulties."[51] The Senate hearings further reveal that the BHCA was preventative rather than responsive; no existing problems were enumerated.[52] The fears that the BHCA addressed could have

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44 OFFICE OF RESEARCH & STRATEGIC PLANNING, *supra* note 32, at 31; Felsenfeld, *supra* note 30, at 64.

45 OFFICE OF RESEARCH & STRATEGIC PLANNING, *supra* note 32, at 31; Felsenfeld, *supra* note 30, at 64.

46 HELLER & FEIN, *supra* note 13, § 17.01[7], at 17-14; OFFICE OF RESEARCH & STRATEGIC PLANNING, *supra* note 32, at 31; Felsenfeld, *supra* note 30, at 64.

47 In 1948, the Federal Reserve brought an action against Transamerica, alleging that it violated section 7 of the Clayton Act by "continuously and systematically" buying up stock of independent commercial banks in five western states: Arizona, California, Nevada, Oregon, and Washington. HELLER & FEIN, *supra* note 13, § 17.01[7], at 17-14. Section 7 of the Clayton Act "prohibits a corporation from acquiring the stock of one or more corporations where the effect may be to substantially lessen competition or tend to create a monopoly." *Id.*; *see also* Clayton Act, § 7, 15 U.S.C. § 18 (2006). The Federal Reserve ordered Transamerica to divest its subsidiary banks and sell its stock of Bank of America, but the order was overturned by the court of appeals. *See* Transamerica Corp. v. Bd. of Governors, 206 F.2d 163 (3d Cir. 1953); *see also* HELLER & FEIN, *supra* note 13, § 17.01[7], at 17-14. This failure to disband the perceived threat to American banking led to enactment of the BHCA by Congress. HELLER & FEIN, *supra* note 13, § 17.01[7], at 17-14.

48 Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841–1850 (2006)).

49 *See* Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 302–05 (1987).

50 *See* Thomas E. Wilson, *Separation Between Banking and Commerce Under the Bank Holding Company Act—a Statutory Objective Under Attack*, 33 CATH. U. L. REV. 163, 166 (1983) (noting that legislators and regulators considered creating a new regulatory scheme based merely on the fear of the possibility of commingling banking and commerce in a single corporate entity).

51 101 CONG. REC. 7957 (1955) (statement of Rep. Harris Ellsworth).

52 Halpert, *supra* note 20, at 496–98 (explaining that the position of the Board of Governors of the Federal Reserve, which favored restricting bank holding companies from engaging in

been alleviated by adequate supervision instead of a complete ban on commercial ownership of banks.

Nevertheless, the BHCA was the first regulatory action that attempted to separate banking from commerce at the ownership level. The BHCA, as enacted in 1956, regulated companies that owned two or more banks and was designed to keep bank ownership decentralized.[53] The BHCA's primary purpose was to avoid the aggregation of banking resources in one organization and to prevent the undue concentration of power that might result when banking and nonbanking units were organized under one corporate firm.[54]

Even after the passage of the BHCA, the prohibition of commercial ownership of banks was not absolute. Any company could still own one bank.[55] The BHCA was aimed at preventing "bigness" in banking, and these one-bank holding companies were not considered a threat until they started to grow in size and number.[56] As one-bank holding companies started to grow and expand, the BHCA was amended to cover them as well.[57] In 1970, the BHCA was amended to restrict commercial firms from owning even one bank unless the firm met the definition of a Bank Holding Company ("BHC") under the

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nonbanking business, "contravened both history and logic"). In the Senate hearings, the Board was unable "to identify any actual problem of 'conflicts of interests.'" *Id.* at 498 (citing *Control of Bank Holding Companies: Hearings on S. 880, S. 2350, and H.R. 6227 Before the Subcomm. of the S. Comm. on Banking and Currency*, 84th Cong., 1st Sess. 64–65 (1955) (statement of J.L. Robertson, member, Board of Governors of the Federal Reserve System)). When a member of the Board was questioned whether existing "banks controlled by the bank holding companies make loans to industrial enterprises which the bank holding companies own," he replied that he could not "think of a single violation." *Control of Bank Holding Companies, supra*, at 64 (statement of J.L. Robertson, member, Board of Governors of the Federal Reserve System). When pressed further to name specific harms caused by banking and commercial affiliations, he was unable to do so, but rather stated that "Congress should take into consideration the potentialities involved." *Id.* at 65.

53 Felsenfeld, *supra* note 30, at 67.

54 S. Rep. No. 84-1095, at 2 (1955), *reprinted in* 1956 U.S.C.C.A.N. 2482, 2483 (citing the following as purposes of the BHCA: "(1) [t]he unrestricted ability of a bank holding company group to add to the number of its banking units, making possible the concentration of commercial bank facilities in a particular area under a single control and management; and (2) [t]he combination under single control of both banking and nonbanking enterprises, permitting departure from the principle that banking institutions should not engage in business wholly unrelated to banking"); *see also* Felsenfeld, *supra* note 30, at 79.

55 Carl A. Sax & Marcus H. Sloan III, Legislative Note, *The Bank Holding Company Act Amendments of 1970*, 39 Geo. Wash. L. Rev. 1200, 1208 (1971).

56 *See id.* at 1200.

57 *Id.* at 1213.

BHCA.[58] This amendment initiated the complete separation of banking and commerce in commerce.[59]

Despite the BHCA's attempt at complete separation, there were many commercial firms that owned and controlled banks through exceptions and loopholes in the BHCA. For example, the BHCA defined a bank as an institution that both accepted deposits and made commercial loans.[60] Many companies owned banks that engaged in one activity and not the other.[61] There were also many other types of banks that did not meet the exact definition of a bank provided in the BHCA. These banks were referred to as "nonbank" banks.[62] After the passage of the 1970 amendment, "nonbank" banks became very popular.[63] In 1987, the Competitive Equality Banking Act ("CEBA")[64] was passed to address this expansion. CEBA broadened the BHCA's definition of bank to cover many nonbank banks, making their owners subject to the activity restrictions of the BHCA.[65] Commercial firms were forced to either divest themselves of their banking affiliates or become BHCs and stop their commercial activities.[66]

However, even CEBA did not cover all commercial ownership of banks.[67] CEBA grandfathered many banks already owned by commercial firms and provided several substantial exceptions to its definition of a bank.[68] Moreover, CEBA allowed exceptions for other nonbanks such as credit card banks, foreign banking institutions, savings associations, trust companies, credit unions, industrial banks, and banks in liquidation.[69] Thus, a commercial firm could still own a

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58 Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 101, 84 Stat. 1760. This would require, inter alia, that the firm "divest [itself] of non-banking affiliates and refrain from future acquisition of such enterprises." Sax & Sloan, *supra* note 55, at 1206. "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." Wilmarth, *Wal-Mart*, *supra* note 14, at 1568.

59 *See* Sax & Sloan, *supra* note 55, at 1228.

60 Bank Holding Company Act Amendments of 1970, sec. 101, § 2(c), 84 Stat. at 1762.

61 Haubrich & Santos, *supra* note 17, at 147.

62 *Id.*

63 *See id.*

64 Competitive Equality Banking Act (CEBA) of 1987, Pub. L. No. 100-86, § 101, 101 Stat. 552, 554 (codified at 12 U.S.C. § 1841(c) (2006)) (defining banks as institutions insured by the FDIC or that accept demand deposits and make commercial loans).

65 S. REP. NO. 100-19, at 2–6 (1987), *reprinted in* 1987 U.S.C.C.A.N. 489, 492–96.

66 *Id.*

67 Blair, *supra* note 12, at 99 (noting that CEBA "grandfathered" some existing nonbank banks).

68 CEBA § 101, 101 Stat. at 554; Blair, *supra* note 12, at 99.

69 CEBA § 101, 101 Stat. at 554. Industrial banks have also been referred to as Industrial

banking entity, which could perform many of the functions of a bank, but was not considered a bank by the BHCA. After the passage of CEBA, demand for these exempted nonbanks skyrocketed.[70] Part III addresses these entities and specifically analyzes the industrial bank, its structure, and its relationship with commercial firms as a successful example of a commerce-banking alliance.

The BHCA's prohibition of commercial ownership of banks is an outdated and unnecessary relic of history and needs to be reconsidered. The recent crisis has illuminated several glaring problems with our current banking system and many of these problems can be remedied by allowing commercial firms to own banks. Commercial firm ownership of banks will naturally cure the problems of homogenization, conglomeration in banking, and the incentives towards risktaking. A measured policy that allows commercial firms to own banks can encourage the provision of banking services while avoiding the moral hazards that are a seemingly permanent part of our current banking policy. Allowing commercial firms to own banks is an idea whose time has come.

B. The BHCA Does Not Fit the Current Banking Landscape

Even if the fears that precipitated enactment of the BHCA had been real enough to justify the Act, the banking industry in 1956 was very different than it is now. It was much easier to erect barriers to entry then, when banks were defined by a few recognizable characteristics. The BHCA's prohibition of commercial ownership of banks led to some important changes in banking. The BHCA spurred the evolution of nonbanks, which eventually blurred the lines of banking and allowed commercial firms to operate bank-like structures.[71] In addition, advances in the financial and capital markets and the need for diverse funding sources led to alternative lending and investing structures that filled in the gaps left by traditional banks.[72] Bank-like enti-

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Loan Companies, but in the state of Utah, the statute governing the entities refers to them as industrial banks. UTAH CODE ANN. §§ 7-8-3 to -21 (LexisNexis 2006); *see also* Mehrsa Baradaran, *The ILC and the Reconstruction of U.S. Banking*, 63 SMU L. REV. 1143, 1145 n.12 (2010). "ILC" and "industrial bank" are used interchangeably throughout this Article.

70 Mindy West, *The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective*, SUPERVISORY INSIGHTS, Summer 2004, at 5, 9.

71 Haubrich & Santos, *supra* note 17, at 147; *see also* Christian Johnson & George G. Kaufman, *A Bank By Any Other Name . . .*, FED. RES. BANK CHI. ECON. PERSP., Fourth Quarter 2007, at 37, 37, 41.

72 *See* 1 DIV. OF RESEARCH & STATISTICS, FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 5 (1997) (discussing the changes in the 1980s and noting the expansion of banking alternatives and new funding sources).

ties have emerged to provide many of the same services that were once exclusively provided by banks.[73]

Banks were once at the center of all lending and investing activities, but today they must compete with a variety of commercial lenders as well as the ever-accessible capital markets.[74] Banks are no longer the only source of liquidity as they once were[75] due to the capital markets,[76] the commercial paper markets,[77] and various other nonbank sources of loans and liquidity. In addition, advances in technology[78] and the elimination of legal geographical barriers, such

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73 In his seminal article, *Are Banks Special?*, E. Gerald Corrigan argues that banks are special because they "offer transaction accounts," provide the "backup source of liquidity for all other institutions," and "are the transmission belt for monetary policy." Corrigan, *supra* note 15, at 7, 13–14.

74 *See* Blair, *supra* note 12, at 100. Corrigan further elaborates that although each characteristic is individually important, it is "the relationship among them that best captures the essence of what makes banks special." Corrigan, *supra* note 15, at 7.

75 *See* Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 WASH. U. L.Q. 769, 772–73 (1991). Additionally, Macey and Miller walk through the three ways that banks used to have the "edge" on the market. *Id.* Traditionally, banks were a unique financial intermediary with the ability to convert illiquid investments to liquid assets. *Id.* at 772. Banks maintained central intelligence on information, which gave them a competitive advantage in the costly process of assessing credit and investing money. *Id.* at 772–73. In the 1970s and 1980s, however, many large corporations switched from bank loans to securitized debt. 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, 231–34. Other lenders emerged over time, which removed the need for traditional bank liquidity. *See id.* Because some of these competitors, such as mutual funds, produced higher yields to investors, customers started shifting funds from banks to these alternatives. *Id.*

76 Biagio Bossone, *What Makes Banks Special? A Study of Banking, Finance, and Economic Development* 48 (World Bank Fin. Sector Strategy & Policy Dep't, Working Paper No. 2408, 2000), *available at* http://go.worldbank.org/68P6Q865Y0. The rise of capital markets and other sources of liquidity are a result of advances in technology that allow for the dissemination of information to which banks had exclusive access in performing intermediary functions. Macey & Miller, *supra* note 75, at 773. There are many financial products that are unaffiliated with banks that have gained popularity because of their efficiency, making banks less central and "special" as a necessary financial intermediary. *Id.* at 774.

77 Commercial paper is an example of a "highly liquid, low-risk asset" and has become one of the most important financial instruments in the past few decades. Dusan Stojanovic & Mark D. Vaughan, *The Commercial Paper Market: Who's Minding the Shop?*, REGIONAL ECONOMIST, Apr. 1998, at 6, *available at* http://www.stlouisfed.org/publications/re/articles/?id=1758. Commercial paper functions much like an IOU, and companies deal these short-term debts to fund day-to-day operations. *Id.* at 5. Commercial paper use increased in the 1980s and 1990s and significantly reduced the amount of company spending that was previously financed through bank loans. *Id.* at 6–7. After 1970, large corporations were moving en masse from bank loans to the commercial paper market. *Id.* Large firms were able to meet their credit needs through capital markets, and nonbank commercial loans offered competition to banks. *Id.*

78 The technology boom of the 1990s was as game changing for the banking sector as it was for most of the business world. Internet banking allows for heightened competition across state and country borders. *See* Wilmarth, *supra* note 75, at 269. Because of these advances, perform-

as the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994,[79] have effectively exposed banking to new competitors and larger markets.[80] Thus, banks are no longer the repository and origin of all money, but merely one competitor in a larger market.[81] Increasingly, banks are one of many competitors that offer lending and investing options. This trend in banking toward greater expansion, competition, and flexibility runs counter to the BHCA's requirement that banks must be owned by BHCs that primarily engage in a laundry list of what are considered core banking activities.[82]

Years of deregulation, coupled with market needs, have introduced many new players into the banking world and have eroded previously impervious barriers between banking and commerce. In response, many have recently argued that core banking laws and separations should be shored up.[83] However, the proverbial genie is out of

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ing transactions and distributing information is easier, cheaper, and more accessible to financial entities other than banks. *See id.* at 297–98. The technological advances of the 1980s and 1990s allowed financial markets to draw from a wider spectrum of borrowers. *Id.* at 230. Computer and statistical tracking allowed nonbanks to evaluate and disseminate data about different kinds of borrowers, a practice that previously had only been profitable to banks. *See id.* at 230–31. Traditional banks faced competition as nonbank entities began providing fast and cost-effective banking services. *Id.* at 231.

79 Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended in scattered sections of 12 U.S.C.).

80 The Riegle-Neal amendment effectively withdrew geographic restrictions on banks. *See* Stacey Stritzel, Note, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation*, 46 SYRACUSE L. REV. 161, 163, 170, 173 (1995). Banks had previously used BHCs as vehicles for interstate banking, but with the branching restrictions removed, banks could move freely on their own. *Id.* at 170, 173. The expansion of banks across state lines was aided by technological advancements. *See* Martha Vestal Clarke, *The Impact of Emerging Payment Systems and Products on Banking Competition and the Competitive Analysis of Bank Mergers and Acquisitions,* 16 ANN. REV. BANKING L. 161, 164–65 (1997) (explaining that virtual, online banking offers a wide range of services, including account managing, bill pay, loan applications, investment accounts, and retirement planning).

81 Finance companies, securities firms, and nondepository lenders have also expanded into the consumer loan market, providing fierce competition for consumer lending, which was traditionally monopolized by banks. Wilmarth, *supra* note 75, at 238. Firms can easily raise capital by extending public offerings, where they rely on "market forces" rather than on intermediary banks to value the investments. *See* Macey & Miller, *supra* note 75, at 773. The emergence of capital markets has encroached on the province of traditional banking by removing the need for the bank to analyze investments; capital markets also give firms access to thousands of financial analysts who can evaluate the public offering market. Customers are not using a traditional bank for all their banking needs anymore. They are turning to nonbanks such as "thrifts, credit unions, annuities, mutual funds, and other securities and insurance products." Lynn W. Woosley, et al., *Is Commercial Banking a Distinct Line of Commerce?*, FED. RES. BANK ATLANTA ECON. REV., Fourth Quarter 2000, at 39, 52–53.

82 *See* Blair, *supra* note 12, at 108–09, 111.

83 *See, e.g.*, MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION (2009) (indicating that the current system is unable to deal with new financial

the bottle, and it would be impossible and unwise to undo the natural evolution of financial markets. Regulators should focus on ordering and controlling the world we are in rather than the banking world that might have been.

In the wake of these changes in the financial world, the regulatory structure needs to adjust. The idea that bank ownership should still be governed by a structure developed fifty years ago due to fears of banking monopolies is unreasonable. Banks must compete with several other business models, yet they are bound by antiquated declarations of public fear. In addition, outdated mandates of the past, such as the BHCA, have caused several obstacles to sound banking when applied to a changed banking landscape.

II. THE BANK HOLDING COMPANY ACT AND THE BANKING CRISIS

Given the seriousness of the turmoil sweeping over the banking system and how much worse the crisis could have been,[84] it is no accident that Congress stepped in with sweeping reforms on the heels of the banking crisis. Indeed, Dodd-Frank, passed by Congress in July 2010, represents the most expansive change in financial regulation since the 1930s.[85] Dodd-Frank is comprehensive and addresses some of the immediate causes of this crisis.[86] However, it is uncertain whether Dodd-Frank is enough or too much. It ambitiously sets out to reduce risk in the banking system and gird up our banks to resist

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instruments); Jackie Calmes & Louis Uchitelle, *Obama Will Seek Limits on Banks*, N.Y. TIMES, Jan. 21, 2010, at A1 (quoting Paul Volcker as advocating more separation of banking and commerce to help remedy the financial situation).

84 The financial crisis crippled our economy to the point that "banks could not operate without government assistance, and businesses were unable to raise capital." *Hearing with Treasury Secretary Geithner Before the Cong. Oversight Panel*, 111th Cong. 31 (2010) (written testimony of Timothy Geithner, Secretary, U.S. Department of the Treasury). Additionally, it was more difficult for consumers to obtain loans than any time since the great depression. *Id.* Amidst these concerns, the government responded with reforms and statutory regulations that reduced the cost of credit, increased companies' abilities to hire, reinvested in small businesses, and helped clean up the financial statements of financial and banking institutions. *Id.* at 32. These changes helped stabilize the financial system and helped to avoid a systematic failure of the financial industry. *Id.*

85 President Obama described it as "the most far-reaching reform since the Great Depression." Press Release, The White House, Office of the Press Sec'y, Statement from the President on the Passage of Financial Reform (June 30, 2010), *available at* http://www.whitehouse.gov/the-press-office/statement-president-passage-financial-reform.

86 *See generally* U.S. SENATE COMM. ON BANKING, HOUS., & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (describing the major provisions of the Dodd-Frank Act).

bubbles and shocks, but it is quite difficult to test its strength. Because each crisis is unique, the real proof of the Dodd-Frank's effectiveness will not be adequately demonstrated until the next crisis. Clearly, however, Dodd-Frank accomplishes many things. For example, it attempts to reduce systemic risk by regulating the activities that can be conducted within a bank,[87] ensures heightened disclosure,[88] requires more capital to offset risks,[89] and creates overseers to monitor systemically important financial firms.[90] Although it attempts to reduce systemic risk, it does not address the adverse risk structure of privatized gains and public losses inherent in our current banking system.

In the debate leading up to the passage of Dodd-Frank, several theories of banking reform were proposed. Many of these proposals were mired in regulation-speak, based on the assumption that regulating something would make it go away.[91] However, unless the strong incentive banks have to engage in risktaking is somehow diminished, banking regulators will always be chasing innovation on Wall Street that is aimed at increasing profits.

Although this Article does not aim to cure this risk structure, it does propose one possible banking framework that does not suffer from the moral hazards prevalent in banking. Accordingly, this Article argues that relaxing strict adherence to the principle of separation of banking and commerce would reduce systemic risk. For several reasons, commercial ownership of banks could solve at least some of the problems noted above.

The BHCA was intended to deter conglomeration in banking and reduce systemic risk, but it has had just the opposite effect.[92] Relaxing the requirements of the BHCA, coupled with improved oversight, would result in a more diverse and secure banking structure. Easing

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87 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 601–628, 124 Stat. 1376, 1596–1641 (2010) (to be codified in scattered sections of 12 U.S.C.).

88 *Id.*

89 *Id.* § 606.

90 *Id.* §§ 151–156.

91 The Treasury and the Federal Reserve proposed reducing leverage by increasing the amount of capital banks are required to hold. David Wessel, *Three Theories on Solving the 'Too Big to Fail' Problem*, WALL ST. J., Oct. 28, 2009, at A2. The second approach, which was incorporated into Dodd-Frank and dubbed the "Volcker Rule," was to restrict the type of activities—specifically proprietary trading—in which banks could engage. Others pushed for a dismantling of the largest banks—those deemed too big to fail ("TBTF"). *Id.* Advocates of the latter strategy argued that a bank that is TBTF should not be allowed to stand. *Id.*

92 *See* Note, *The Demise of the Bank/Nonbank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies*, 98 HARV. L. REV. 650, 656–58 (1985).

some of the BHCA's restrictions on commercial ownership of banks could solve a few of the current problems plaguing the banking system: banks are too large and too homogenized to resist a contagion, and too structurally risk prone.[93] This Part examines these three major problems in banking that have been at least partly caused by the BHCA and illustrates how commercial ownership of banks can mitigate them.

A. *Banks Are Too Large*

The restrictions of the BHCA have caused a conglomeration in banking that has been further accelerated by the recent banking collapse, an ironic result of an act meant to combat conglomeration in banking. Because the BHCA mandates that a holding company be engaged only in banking and does not allow commercial firms to affiliate with or own banks, banks can only merge other banks. The last decade has seen a significant trend toward bank mergers, as they began to accelerate in the 1980s and continued through the 1990s.[94] Since 1980, the number of FDIC-insured entities has declined from 16,000[95] to 7417.[96]

The collapse of the subprime mortgage market in 2007 resulted in a number of mergers among the biggest banks in the United States.[97]

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93 See *infra* Part II.B.1 for a description of contagion as a result of homogenization.

94 *See* Edward Pekarek & Michela Huth, *Bank Merger Reform Takes an Extended* Philadelphia National Bank *Holiday*, 13 FORDHAM J. CORP. & FIN. L. 595, 604 (2008). Mergers were possible despite the Bank Merger Act of 1960 ("BMA"), 12 U.S.C. § 1828 (2006), which was originally enacted to support the BHCA's procompetitive purpose. Pekarek & Huth, *supra*, at 615. However, a large loophole in the BMA allows for mergers if the anticompetitive effects are outweighed by the public interest of "the convenience and needs of the community to be served." H.R. REP. NO. 86-1416 (1960), *reprinted in* 1960 U.S.C.C.A.N. 1995. Additionally, federal authorities relaxed the merger review standards after 1980 with the apparent attitude that relaxed standards would encourage competition and allow larger, more efficient banks to absorb smaller banks. Wilmarth, *supra* note 75, at 250–51.

95 Pekarek & Huth, *supra* note 94, at 604.

96 *Institution Directory*, FED. DEPOSIT INS. CORP., http://www2.fdic.gov/idasp/ (last updated Nov. 10, 2011).

97 In 2008, in the wake of the crisis, stable financial firms such as Bank of America, Wells Fargo, JPMorgan Chase, and other large banks bought failing or weakened banks. Bank of America acquired Countrywide, a mortgage provider facing potential failure due to the mortgage crisis, in January 2008. Shannon D. Harrington & Hamish Risk, *Bank of America Credit Risk Increases on Countrywide Purchase*, BLOOMBERG (Jan. 11, 2008, 5:38 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRgBATAK.v4E. In March, news that Bear Stearns was close to filing bankruptcy led JPMorgan to step in at the behest of the federal government and acquire the failing investment bank at ten dollars per share. American Banker Staff, *Year in Review: When It Seemed Things Couldn't Get Worse . . .*, AM. BANKER, Dec. 5, 2008, at 30. In September 2008, Bank of America acquired Merrill Lynch, a move that federal regulators leveraged to ensure that Merrill Lynch's failure would not further bring down the

Consolidation has led to domination of the market by a few institutions.[98] Currently, three banks—Bank of America, JPMorgan Chase, and Wells Fargo—control over thirty-three percent of Americans' bank deposits.[99] The mortgage industry is dominated by Wells Fargo and Bank of America,[100] and five residential servicing firms now control over two-thirds of the nation's housing debt.[101] These large BHC conglomerates control a staggering market share and are so dominant in the banking sector that they have made it increasingly difficult for smaller banks or new entrants in the market to compete.[102] Even though banking is still less concentrated than most other major American industries, this trend toward conglomeration is problematic.

The crisis led stronger banks to seek out failing banks to acquire and consolidate,[103] and as the downturn levels off, even more acquisi-

economy. Steven Sloan, *When A Job Becomes a Policy Lever*, AM. BANKER, July 17, 2009, at 1. The same month, JPMorgan made another acquisition; this time it bought the faltering firm Washington Mutual. Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1. Caught in crisis, Morgan Stanley considered a merger with Wachovia, the fourth largest bank. Andrew Ross Sorkin & Eric Dash, *Morgan Stanley Is Said to Press for Merger with Wachovia*, N.Y. TIMES, Sept. 19, 2008, at C7. But suffering its own losses from bad mortgages, Wachovia was pushed into a quick sale. Eric Dash & Andrew Ross Sorkin, *Regulators Push for Sale of Wachovia*, N.Y. TIMES, Sept. 29, 2008, at A15 (noting that Wachovia's share price had plunged nearly seventy-four percent). Citigroup and Wells Fargo spent the end of 2008 competing for the ownership of Wachovia, but Wells Fargo won with a $15.1 billion offer, beating Citi's $2.16 billion offer. Kevin Dobbs, *Citi Deal Bought Time for Wachovia, and for Wells*, AM. BANKER, Oct. 6, 2008, at 2.

98 *See* Matt Ackermann, *Big 3 Deposit Share Approaches 33%*, AM. BANKER, Oct. 28, 2008, at 16; Kevin Dobbs & Paul Davis, *Assessing the '09 Outlook for Giants*, AM. BANKER, Dec. 23, 2008, at 1; Shanker Ramamurthy & Suzanne Duncan, Viewpoint, *Crisis Presents an Opportunity for Reinvention*, AM. BANKER, Dec. 3, 2008, at 10.

99 Ramamurthy & Duncan, *supra* note 98.

100 Kate Berry, *Mortgages' Big Two Are Too Big to Avoid*, AM. BANKER, Sept. 28, 2009, at 1.

101 Paul Muolo, *In the Servicing Market, the Biggest Get Bigger*, AM. BANKER, Feb. 17, 2009, at 10.

102 Berry, *supra* note 100 (discussing soaring costs for smaller mortgage lenders).

103 Robert Barba, *After Corus, Serial Buyer is Now Pausing to 'Digest,'* AM. BANKER, Sept. 15, 2009, at 1 (discussing MB Financial's acquisition of Corus bank in September 2009 and its plan to "peek" at other, future acquisition opportunities); Robert Barba, *Capitol of Mich. Retrenches with an Eye to Acquisitions*, AM. BANKER, Oct. 17, 2008, at 1 (describing Capitol Bancorp's plan to consolidate seven branches into three and start "thinking more seriously about acquisitions"); Dobbs & Davis, *supra* note 98 (reviewing a number of 2008 acquisitions including U.S. Bancorp's acquisition of Downey Financial Corp. and JPMorgan, and Chase's acquisition of Bear Stearns and Washington Mutual); Kevin Dobbs, *Treasury Lends Hand to Nat City—PNC Deal*, AM. BANKER, Oct. 27, 2008, at 1 (reporting PNC's takeover of failing National City in October 2008); Alan Kline, *N.J. Bank, Thrift Groups to Join Jan. 1*, AM. BANKER, Dec. 12, 2008, at 5 (covering New Jersey Bankers Association's merger with the New Jersey League of Community Bankers at the beginning of 2009); Matthias Rieker, *Profits Off, First Charter Prepping*

tions are anticipated.[104] Banks that hope to gain momentum by increasing their own presence, expanding their geographic reach, and growing their capital are on the lookout for potential merging partners.[105] Indeed, mergers are a natural result of an economic downturn:[106] when a bank starts to falter, it can hedge its losses by combining with a stronger bank.[107] After the recent crisis, many larger banks were poised to acquire smaller institutions.[108] The largest banks in the country combined to create larger conglomerates, and regional and national banks followed the same trend.[109]

Federal regulators have played a key role in encouraging bank mergers during the recent recession.[110] Regulators use acquisitions "in times of distress to spread capital across the banking system to fill in the weak spots."[111] The government has stepped in as an intermediary or sponsor of major acquisitions by, for example, encouraging JPMorgan to buy Bear Stearns and offering Wall Street institutions

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for New Owner, AM. BANKER, May 8, 2008, at 20 (reporting that Fifth Third Bancorp received approval to acquire First Charter Corp.).

104 David Henry & Dakin Campbell, *Get Ready for a Wave of Bank Mergers*, BLOOMBERG BUSINESSWEEK, Sept. 20–26, 2010, at 51 (reporting that "conditions make the industry ripe for a wave of takeovers," even though the four largest banks "won't be doing any significant buying").

105 Robert Barba, *Minn. Deal May Illustrate Tiny Consolidation Trend*, AM. BANKER, Sept. 29, 2009, at 1 (describing an acquisition in which a Minneapolis–St. Paul bank having twenty-two branches "would gain one branch in a suburb where it would like to be").

106 Dino Mauricio, Viewpoint, *Despite Turmoil, M&A Strategies Remain Viable*, AM. BANKER, June 6, 2008, at 10 ("Depressed valuations, fewer competing bids, and stronger negotiating ability at the deal table will translate into attractive opportunities for banks to put excess capital to work.").

107 *See* Jenny Anderson, Andrew Ross Sorkin & Ben White, *As Options Fade, Lehman Is Said to Seek a Buyer*, N.Y. TIMES, Sept. 12, 2008, at A1 (explaining that this was the hope of Lehman Brothers when it considered selling itself after it hit record losses).

108 Kevin Dobbs, *Buying, Selling, and the Question of Timing*, AM. BANKER, Jan. 14, 2008, at 7 (discussing rumors that JPMorgan Chase would acquire Washington Mutual, among others).

109 *See* Matthew L. Cantor, Viewpoint, *Rethinking M&A Antitrust Enforcement*, AM. BANKER, Feb. 20, 2009, at 11 ("With many banks having sustained heavy losses of late, some observers say a wave of financial institution consolidation may be upon us."); *see also supra* note 97 and accompanying text.

110 Camden Fine, Viewpoint, *The Bitter Fruit of Unchecked Consolidation*, AM. BANKER, Sept. 19, 2008, at 10 ("[F]or nearly 30 years, official government policy best articulated by the Treasury and the Fed has encouraged and supported the consolidation of the entire financial services spectrum, which has led to the dangerous 'interconnectedness' of mammoth institutions worldwide.").

111 Rob Cox, Editorial, *Too Many Banks 'Too Big to Fail,'* N.Y. TIMES, Oct. 20, 2008, at B2 (arguing that although government-encouraged mergers might provide stability in the short term, such mergers threaten the financial system by facilitating "too big to fail" bailouts); *see also infra* Part II.A.1.

funds for acquisitions in the fear that more banks could fail unless they were merged.[112]

Consolidation in banking was not limited to the largest banks.[113] Small and midsized banks were left in a particularly weak and vulnerable position due to the recent crisis, and many faced the prospect of merging or perishing.[114] This acceleration of mergers and small bank failures has led to diminished numbers of these banks.[115] The loss of so many of these smaller banks affects the financing prospects of many small and midsized businesses, which are the main customers of these banks.[116] Currently, there is a shortage of financing options for these types of businesses as large banks conglomerate and chase after higher-yielding investments.[117] Thus, the very regulatory structure designed to promote competition and discourage conglomeration has in fact led to a structure where a few large and powerful banks control the majority of the banking sector and the banking needs of entire business segments go unmet.

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112 *In Bear Bailout, Fed Says It Tried to Avert Contagion*, N.Y. TIMES, June 28, 2008, at C4 (reporting that the Fed "felt compelled to intervene because an 'immediate failure' of Bear Stearns would bring about an 'expected contagion'").

113 The subprime crisis affected the housing industry and with housing projects drying up, small banks' usual clients stopped borrowing. Eric Dash, *Small and Midsize U.S. Banks Beginning to Struggle in Credit Crisis*, N.Y. TIMES, Feb. 27, 2008, at C3. In addition, the Treasury Department typically did not assist small banks through the Troubled Asset Relief Program, given that the objective of the program was to keep big banks alive. Robert Barba, *The Real 'Scarlet Letter' Was* Not *Receiving Tarp*, AM. BANKER, Sept. 17, 2009, http://www.americanbanker.com/issues/174_180/real_scarlet_letter_not_receiving_tarp-1002155-1.html. This left small and midsized banks to fend for themselves, and some either disappeared, downsized, or were swallowed up by bigger banks. *Id.* Some private investors started buying up small failed banks, and creating bigger bank companies. Marissa Fajt, *Tex. Buyout Group Has Two Deals, Focus on Fort Worth*, AM. BANKER, Mar. 24, 2008, at 4. For example, Texas American Acquisition Inc. began buying up closing community banks in Forth Worth. *Id.*

114 *See* Rob Cox & Jason Bush, *Red Flags Ahead for Smaller Banks*, N.Y. TIMES, Dec. 29, 2009, at B2.

115 After the major banks stabilized through mergers, small banks still struggled and small bank failures accelerated in 2009. Graham Bowley, *More Small Banks Ailing as Recession Toll Mounts*, N.Y. TIMES, May 28, 2009, at B3. The 2007 crisis year saw only three bank failures. *Failed Bank List*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/bank/individual/failed/banklist.html (last updated Oct. 25, 2011). But in 2008, the number had grown to 25, and in 2009, 140 banks failed. *Id.* Most of the 140 were small banks. *See* Cox & Bush, *supra* note 114. Many small banks became easy candidates for acquisitions. *See* Dash, *supra* note 113.

116 *See* Dash, *supra* note 113.

117 Scott Medintz, *Getting the Loan Officer on Your Side: Small Banks Will Lend if They Understand the Business*, N.Y. TIMES, May 28, 2009, at B8 (describing the strategies small business owners must employ to find financing as large banks have tightened their lending to small businesses).

1. "Too Big to Fail" Bailouts and Dodd-Frank

One particularly problematic result of the increased conglomeration in banking is the implicit government promise that large firms will be deemed "too big to fail" ("TBTF") and aided by federal funds when failures seem imminent.[118] This implicit guarantee is troubling, as it creates moral hazard and can lead to excessive risktaking.[119] The TBTF protection is also an incentive for conglomeration because it rewards large banks with Federal Reserve protection—naturally, regulators may be more comfortable allowing smaller banks to fail.[120]

One of the provisions of Dodd-Frank promises to end future bailouts of banks that are TBTF, but if BHCs continue to be large, interconnected, and highly leveraged, the promise is not realistic.[121]

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118 Section 141(a)(i)(C) of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified at 12 U.S.C. § 1823(c)(4)(G)(i)(I) (2006)), essentially codified a TBTF policy by providing that the FDIC would protect uninsured depositors in large failing banks if the action is taken to prevent "serious adverse effects on economic conditions or financial stability." *Id.*; *see also* Wilmarth, *supra* note 75, at 300. But describing a firm as "too big to fail" is a bit of a misnomer because size is only one factor used in determining if a bank's failure will have "serious adverse effects on economic conditions or financial stability." TBTF is also known as "too interconnected to fail" or "systemically important financial institutions." John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 812 (2010); James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation*, 8 DEPAUL BUS. & COM. L.J. 135, 139 (2010).

119 For an overview of moral hazard, see generally Karl S. Okamoto, *After the Bailout: Regulating Systematic Moral Hazard*, 57 UCLA L. REV. 183 (2009).

120 TBTF protection has caused the absorption of smaller banks by larger ones. *See* Krishnamurthy V. Subramanian, Column, *How to Fix Global Finance*, FIN. EXPRESS (May 26, 2010, 8:04 PM), http://www.financialexpress.com/news/column-how-to-fix-global-finance/623548/0; *cf.* Linda O'Connell, *Can Community Banks Compete?*, NW. FIN. REV., Apr. 15, 2001, at 6, *available at* http://www.allbusiness.com/finance-insurance/896834-1.html (showing statistics that small companies prefer small banks' services and products).

121 Testifying before the Financial Crisis Inquiry Commission, Federal Reserve Chairman Ben Bernanke was asked whether institutions that had become too large to manage should be broken up. *Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n*, 45–47 (testimony of Byron S. Georgiou, Comm'r, Financial Crisis Inquiry Commission), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0902-Transcript.pdf. Chairman Bernanke responded that size is not the issue, but instead that management's ability to monitor and mitigate risk is. *Id.* at 47–48. Bernanke also said that with the passage of Dodd-Frank, "it would [not] be feasible for us to bail out firms the way we did during the crisis." *Id.* at 44–45. Although the particular method of bailing out a financial institution has been curbed, however Bernanke seemingly did not want to take the stance that FDIC Chairman Sheila Bair did in saying, "There is no wiggle room for bailouts here. No more bailouts." Dave Clark, *FDIC Sees Rule Early Next Year on Dismantling Firms*, REUTERS, Aug. 31, 2010, http://www.reuters.com/article/2010/08/31/us-financial-regulation-resolution-idUSTRE67U4GU20100931. Rather, Bernanke's written comments potentially foreshadow future political pressure to rescue troubled institutions: "Few governments will accept devastating economic

Experts have noted that future bailouts are still likely to occur.[122] An expectation of future bailouts also lingers in the financial sector. Standard & Poor's continues to rate four large financial institutions—Bank of America, Goldman Sachs, Morgan Stanley, and Citigroup—as possessing "extraordinary sovereign support," thus increasing their rating quality.[123] Experts note that bailouts will likely continue in private, with the Federal Reserve directing the movements.[124] Perhaps bailouts will become even more likely under Dodd-Frank because there are now formal procedures in place.[125]

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costs if a rescue can be conducted at a lesser cost; even if one Administration refrained from rescuing a large, complex firm, market participants would believe that others might not refrain in the future. Thus, a promise not to intervene in and of itself will not solve the problem." *Too Big to Fail*, *supra*, 21–22 (written statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0902-Bernanke.pdf; *see also* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435 (2011) (arguing that bailouts are a necessary response to systemic financial risk).

122 Mark W. Olson, Viewpoint, *What Dodd-Frank Did and Did Not Accomplish*, AM. BANKER, July 30, 2010, http://www.americanbanker.com/issues/175_145/vp-olson-dodd-frank-bill-1023102-1.html. Mark Olson, former Federal Reserve board governor, explains that the promise of no bailouts will not hold up for several reasons:

> First, all government activities ultimately involve taxpayer dollars, and any financial rescue will involve government intervention. Second, there is an implicit presumption in the construct of the special assessments provision to cover the cost of a rescue that when one failure occurs other fund participants will be sufficiently healthy to provide the funding.

Id.

123 STANDARD & POOR'S, THE FINANCIAL OVERHAUL BILL: THE RULES OF THE ROAD HAVE CHANGED, BUT DETAILS SHOULD DEFINE BY HOW MUCH 2 (2010). Standard and Poor's did note, however, that "it is possible based on several provisions in Dodd-Frank . . . that over time we will change our view of sovereign support for U.S. banks to 'support uncertain' under our methodology." *Id.*

124 PETER J. WALLISON, THE DODD-FRANK ACT: CREATIVE DESTRUCTION, DESTROYED (2010), *available at* http://www.aei.org/docLib/FSO-2010-July-August-g.pdf; *see* Olson, *supra* note 122. In addition, Dodd-Frank shifts regulatory power from the FDIC to the Federal Reserve, which has the power (once it takes control of an institution) to strong-arm other large institutions into buying the troubled assets, as was done when Bank of America was forced to buy Merrill Lynch, despite large losses. WALLISON, *supra*.

125 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201–217, 124 Stat. 1376, 1442–1520 (2010) (to be codified in scattered sections of 12 U.S.C.) (providing procedures for the "orderly liquidation" of large financial companies). *But see id.* § 214, 124 Stat. at 1518–19 (mandating that "[t]axpayers shall bear no losses from the exercise of any authority under this title" and that "[a]ll funds expended . . . shall be recovered from the disposition of assets of such financial company, or shall be the responsibility of the financial sector, through assessments").

2. *Commercial Firm Ownership Versus Large Banking Conglomerates*

Commercial firm ownership can counteract the trend toward consolidation and offer small and midsized banks a chance of surviving and even succeeding. The BHCA is at least partly responsible for causing these large and powerful banking conglomerates. Allowing commercial firms to own banks would counter conglomeration in two ways: first, banks funded by large corporations could serve as competition to these BHC giants; second, based on the experience of current commercially owned banks, these banks might better service the needs of the small and midsized banking market.

The potential Wal-Mart bank outraged many in the industry—at the time it was assumed that this would be the largest threat to small banking across the country.[126] But the recent crisis demonstrated that the real threat to banking has come from within the sacred walls of banking and not from the feared intruder. It is the large BHCs that have swallowed up the small banks, leaving them no other choice but to merge. Today, as the conglomerates have taken shape, funded by the taxpayer, a Wal-Mart bank could be a welcome competitor.

If commercial firms could own banks, more small and midsized banks could survive and serve the needs of small and midsized business. These banks could remain small because of the financial backing of a corporation and would not need to be consumed by a BHC. Currently, GE Capital, a banking subsidiary of GE that gained a charter due to an industrial bank "loophole," is thriving by meeting the needs of small and midsized business borrowers.[127] A recent article in *The New York Times* lauded the firm as being one of the only remaining lenders that services the small and midsized business-loan sector with great success.[128] GE Capital can do so because it is not forced to compete with the large banks for its clientele. Due to the backing of its commercial parent, GE Capital is able to leave the herd of large banks competing for the same customers and branch into an area that those banks have left vacant.

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126 *See* Greg Morcroft, *Bank of America Assesses Wal-Mart Plan: CEO Sees Some Competitive Threat from Industrial-Loan Bank*, MARKETWATCH (May 2, 2006, 1:31 PM), http://www.marketwatch.com/story/bank-of-america-ceo-sees-wal-mart-posing-some-threat (describing Bank of America's CEO as claiming that a Wal-Mart Bank's "biggest threat would be to local, community banks").

127 *See* Eric Lipton, *Citing Risks, U.S. Seeks New Rules For Niche Banks: Industry Resists Move*, N.Y. TIMES, Sept. 17, 2009, at A1.

128 *Id.*

These small and midsized banks could resist an otherwise fatal financial contagion, such as a failed product that threatens to wreak havoc on a bank's delicate balance sheet, because they would be able to rely on the backing of a parent company that serves as a true source of strength.[129] Parent firms with stable cash flow would be able to support a subsidiary bank's liquidity problems.[130] This would be especially important during times of financial contagion, when regulators are most concerned about the survival of banks. Moreover, allowing commercial firms to buy troubled banks would decrease the likelihood that such banks would be absorbed into giant financial conglomerates, as is likely today.

B. Homogenization and Correlation

The recent banking crisis exposed many flaws in the U.S. banking system and in the government's ability to regulate it effectively. Among the most disturbing of these revelations was that our current banking structure is too interconnected to resist the spillover effect of systemic shocks as competitors plunge into economic collapse. Given what has transpired, it is not surprising that many have described the financial system as dominos ready to fall,[131] or as a house of cards that was easily toppled when one or two cards fell.[132] As is described below, allowing commercial firms to own banks provides a potential defense against widespread financial panic caused by contagion.

1. The Current Banking System Leaves Individual Banks Ill Equipped to Deal with Contagion

Competition among large banks has caused a homogenization of products and assets. This homogenization contributes to a contagion effect among the commercial banking sector.[133] For example, leading up to the recent crisis, many large banks that were previously not interested in investing in subprime mortgage products could no longer stay away from these high-yield securities; they needed to keep up with their competitors and their businesses were built around con-

129 Baradaran, *supra* note 69, at 1185–87.

130 *Id.*

131 *NewsHour: Examining the Roots of U.S. Economic Woes* (PBS television broadcast Mar. 21, 2008) (using a "falling dominos" analogy to describe the fallout of the financial system).

132 *House of Cards* (CNBC television broadcast Feb. 12, 2009) (using a "house of cards" analogy to describe the events).

133 *See* Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 799 (2010).

tracts and exchanges with their counterparts.[134] Large banks were forced to compete with other large banks by adopting similar practices and accumulating similar financial products.

Banks often "herd" to the same types of assets in order to compete.[135] This behavior causes bank holdings to become highly correlated, which means that they are more likely to stand or fall together.[136] Herding is evidenced through lending strategies: lending to similar industries, specializing in certain products, or lending to similar sets of customers.[137] Bankers also have an incentive to invest in assets that are highly correlated with their counterparts' investments because regulators are unlikely to allow one firm to fail when all the correlated firms would also be affected.[138] This creates a "too many to fail" problem.[139] Such herding behavior was evidenced during the recent financial crisis in the form of overinvestment in subprime and other mortgage-related assets.[140]

Whatever the motivation or method, herding behavior creates highly correlated assets in the banking sector, which increases systemic risk. The high correlation of assets makes it difficult to ensure the health of the banking system by regulating individual banks. Individually, each bank may not pose a systemic risk, but collectively they might.[141]

Thus, the assets held by major banks and BHCs are positively correlated with each other, which means that they move up or down at the same time.[142] Holding positively correlated assets in a portfolio amplifies both gains and losses, which increases (or at least fails to reduce) risk in the portfolio because of a lack of diversification.[143] This risk could be reduced by diversifying assets among sectors so that

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134 Wilmarth, *Dark Side of Universal Banking*, *supra* note 14, at 1032, 1035.

135 Some propose that due to "information contagion," which increases depositors' expected returns from a surviving bank when deposits are transferred from a failed bank, the environment is better for a surviving bank when other banks survive as well, than if one bank survives and another bank fails. Thus, banks consciously invest in correlated assets to ensure that the optimal environment exists. *See* Viral V. Acharya & Tanju Yorulmazer, *Information Contagion and Bank Herding*, 40 J. MONEY, CREDIT & BANKING 215 (2008).

136 *Id.* at 228.

137 *Id.*

138 Thomson, *supra* note 118, at 140.

139 *Id.*

140 *Id.*; *see also* Andrew Kahr, Column, *Blame 'Systemic Risk' on Groupthink*, AM. BANKER, Oct 12, 2010, at 9.

141 Thomson, *supra* note 118, at 140.

142 *See* David M. Darst, THE ART OF ASSET ALLOCATION 65–66 (2d ed. 2008).

143 *See id.* at 89–90.

they are either negatively correlated or uncorrelated with their own assets. Commercial firms can provide much needed diversity.

The close companion of correlation in the banking sector is called "contagion," which is "the spillover of the effects of shocks from one or more firms to others."[144] Contagion in banking is theorized to be more potent than contagion in other sectors, with potential to spread farther and more quickly.[145] Thus, the house of cards or dominos analogies were accurate depictions of what happened to banks as their highly correlated products began to fail.

Conversely, commercial firms are generally less susceptible to contagion,[146] and therefore, a bank owned by a commercial firm would pose less risk of contagion to the financial system. Although the bank may suffer runs when bad news is exposed, its commercial parent company could absorb the effects of runs through reduced revenue or higher prices, slowing the speed of contagion and improving the bank's chances of survival. For example, a Wal-Mart bank could easily become infected with a financial contagion such as defaulting asset-backed securities. However, its parent's operations would not be similarly affected because retail sales are not directly linked to the financial markets. Therefore, it is possible for the parent company's steady revenue stream to buoy a partner or subsidiary bank during a banking crisis.[147]

In banking, there is also a danger of perceived or assumed contagions. This is true because depositors are less likely to be informed about the financial condition of banks, and there is less noticeable distinction between products of one bank compared to another.[148] Thus, when one bank is believed to be on the brink of failure, it triggers

144 George G. Kaufman, *Bank Contagion: A Review of the Theory and Evidence*, 1994 J. FIN. SERVICES RES. 123, 123; *accord* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 418 (1983) ("Consider a firm with illiquid technology which issues very short-term bonds as a large part of its capital structure. Suppose one lender expects all other lenders to refuse to roll over their loans to the firm. Then, it may be his best response to refuse to roll over his loans even if the firm would be solvent if all loans were rolled over. Such liquidity crises are similar to bank runs.").

145 Kaufman, *supra* note 144, at 124 ("In comparison to other industries, absent federal deposit insurance, bank failure contagion is hypothesized to: 1. occur faster; 2. spread more broadly within the industry; 3. result in a larger number of failures; 4. result in larger losses to creditors (depositors) at failed banks; and 5. spread more beyond the banking industry and cause substantial damage to the financial system as a whole and the macroeconomy.").

146 *See id.* at 126 (noting that problems with commercial companies rarely have a long-term harmful impact on their competitors).

147 *See* Baradaran, *supra* note 69, at 1187.

148 Kaufman, *supra* note 144, at 127.

concern about the solvency of other banks.[149] Otherwise–uncorrelated-risk exposures of a few similarly situated banks can become highly correlated during times of financial distress.[150] This is less likely to occur among commercial firms, where information is more readily available and the differences between firms are more readily apparent.[151] Additionally, commercial firms are generally better capitalized than banks and can withstand bigger adverse shocks, reducing the contagion spread as compared with banks.[152]

Evidence of contagion among banks still exists.[153] During the recent crisis, many banks failed because they did not have enough assets that were unaffected by the housing crisis to counterbalance their losses.[154] And once one firm experienced a run or near crisis, the fear caused a contagion through the entire banking system. For example, in 2008, when Washington Mutual collapsed, Wachovia effectively experienced a bank run the very next day.[155] The FDIC was forced to step in and facilitate the merger of Wachovia bank with Citigroup, leaving the Wachovia holding company a shell without any subsidiary.[156]

Exactly how serious the problem of bank contagion is remains unclear. Empirical studies on these theories are mixed; some suggest banks are only very slightly vulnerable, if at all, in relation to other firms with respect to contagion and failure,[157] while others suggest that

149 *Id.*

150 Thomson, *supra* note 118, at 140.

151 Kaufman, *supra* note 144, at 128–29.

152 *Id.* at 133.

153 "The symptoms are familiar: too many construction loans made when money was plentiful and real-estate values defied gravity. And now the disease that has killed more than 200 banks is spreading to another part of the U.S. Six banks in Washington state have failed this year, while about one-fourth of the banks and savings institutions based there are operating under toughened regulatory scrutiny known as 'cease-and-desist' orders, according to the Federal Deposit Insurance Corp." Robin Sidel & Peter Lattman, *Bank Contagion Spreads to Northwest*, WALL ST. J., May 29, 2010, at B1.

154 *See* Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 172–73 (2009) (explaining that in the recent crisis, risk correlation within mortgage-backed securities meant that "when losses do occur, they can be massive," which can also affect assets that do not appear to be directly correlated with the risk).

155 Rick Rothacker & Kerry Hall, *Wachovia Faced a 'Silent' Bank Run*, CHARLOTTE OBSERVER, Oct. 2, 2008, at 1A (reporting that clients started pulling money out and leaving just below the FDIC insured minimum of $100,000).

156 *Id.* Wells Fargo and CitiGroup ended up competing for the chance to buy Wachovia, with Wells Fargo ultimately winning the bidding war. Michael J. de la Merced, *Wells Fargo Wins the War for Wachovia*, N.Y. TIMES, Oct. 10, 2008, at B1.

157 George Kaufman argues: "Are banks 'special' or 'unique' relative to other firms with

contagion risk is clearly evident in banking.[158] In any event, there is some evidence that bank regulators treat contagion as a serious potential problem. Although it is difficult to isolate the motivations of regulators, it is widely believed that the FDIC bailout of Continental Illinois in 1984 and the more recent bailout of Bear Stearns were motivated by fears of contagion throughout the financial system.[159]

2. *Commercial Firms as a Source of Strength*

The Federal Reserve looks to parent companies to be a "source of strength" for their banks, which means a parent company "should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity."[160] However, when ownership is limited to BHCs, the parent companies will often struggle during times of financial distress as much as the subsidiary bank because their assets are tied up in the same financial markets. Many BHCs are mere shell companies that own various banking subsidiaries on which the BHCs' financial health depends.[161]

A better source of strength would be a commercial firm whose revenues are not correlated with the weaknesses of a subsidiary bank. Although the financial sector has been hit hard, many commercial

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respect to failure as some argue? The evidence reviewed in this article suggests that they may be, but only slightly so, without federal deposit insurance, and even more slightly so, with such insurance." Kaufman, *supra* note 144, at 143. He concludes: "[B]ank failures with no or only minimal losses to depositors and no interruptions in lending arrangements or the payments system are neither more contagious nor more damaging than the failures of nonbank firms." *Id.* at 144.

158 Dirk Schoenmaker, of the Ministry of Finance in the Netherlands, writes, "[T]he results from our empirical study are consistent with the existence of contagion risk and are thus opposite to those of [George Kaufman's 1994 study]." Dirk Schoenmaker, *Contagion Risk in Banking*, *in* RISK MEASUREMENT AND SYSTEMIC RISK: PROCEEDINGS OF THE SECOND JOINT CENTRAL BANK RESEARCH CONFERENCE 86, 87 (1998), *available at* http://www.imes.boj.or.jp/cbrc/cbrc-03.pdf. "The empirical results indicate that bank failures are dependent after controlling for macro-economic influences. These results are consistent with the existence of contagion risk in banking. An initial failure could generate further failures without intervention by the authorities." *Id.* at 101.

159 Thomson, *supra* note 118, at 139.

160 Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707, 15,707 (Apr. 30, 1987) (policy statement).

161 For example, Citigroup has more than 170 subsidiaries on which it, the BHC parent, depends for revenue. Citigroup Inc., Annual Report (Form 10-K), Exhibit 21.01 (Dec. 31, 2010) (listing only Citigroup's significant subsidiaries). During the recent crisis, when its subsidiaries were in trouble, Citigroup was unable to come to their aid because it was struggling itself. *See* Eric Dash, *U.S. Is Said to Agree to Raise Stake in Citigroup*, N.Y. TIMES, Feb. 27, 2009, at A1. Instead, the Treasury Department bailed out Citigroup by buying a thirty to forty percent stake in it. *Id.*

firms have remained stable because "their credit arrangements are generally medium- or long-term and not collateralized by assets that can lose their value quickly."[162] In addition, these commercial firms rely on a different revenue stream so when the financial markets are suffering from failed products, such as Collateralized Debt Obligations ("CDOs"),[163] a parent retail firm can still sell other goods to meet a constant demand that is not dependent on the health of the financial markets. If commercial firms could own banks, they could provide stability in a crisis by providing uncorrelated assets, diversity of products, and a consistent revenue source.

When financial firms start to falter, they deteriorate rather quickly, but commercial firms often have a long, drawn-out slide toward bankruptcy. Commercial firms are still subject to some counterparty risk and contagion risk like financial institutions.[164] However, failures of nonfinancial firms happen with less swiftness and intensity.[165] Financial firms operate with highly leveraged capital structures as opposed to commercial firms' more modest risk exposures.[166] Consequently, a commercial firm would likely pose less systemic risk because the parent company would remain stable and dampen the risks of contagion and correlated assets. For example, it took a matter of days for the financial giants Bear Stearns, Washington Mutual, and Lehman Brothers to collapse while many of the Nation's automakers, retail chains, and airlines have been teetering on the brink of bankruptcy for years and even decades, because unlike financial firms, their assets do not disappear overnight.[167]

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162 Peter J. Wallison, Viewpoint, *Collapse Shows Folly of Limiting Ownership*, AM. BANKER, Mar. 27, 2008, at 17.

163 For an explanation of CDOs, see *infra* note 187 and accompanying text. For an in-depth discussion of the involvement of CDOs in the subprime mortgage meltdown, see Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 375–76, 394–97, 401–03 (2008) (identifying anomalies and failures in the financial markets that led to meltdown and examining various hypotheses for why they occurred).

164 James Bullard et al., *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RES. BANK ST. LOUIS REV. 403, 408–09 (2009).

165 *Id.* at 408 (explaining that failures of Enron, WorldCom, and several major airlines and automakers throughout the last decade did not cause any major problems for anyone beyond the stakeholders in those individual corporations).

166 Commercial banks typically have a leverage ratio (debt/total equity) of around twelve; investment banks can have leverage ratios of twenty-five or higher. *See id.* at 409. By comparison, the typical S&P 500 Corporation has a leverage ratio of around two and one-half. *Morningstar Investing Classroom, Course 207: Leverage*, MORNINGSTAR, http://news.morningstar.com/classroom2/printlesson.asp?docId=2936&CN=COM (last visited Oct. 27, 2010).

167 *See* Kaufman, *supra* note 144, at 125.

Banks have illiquid assets (loans) and highly liquid liabilities (deposits), making them susceptible to runs. This illiquidity and vulnerability increases systemic risk.[168] By contrast, commercial firms typically have medium- to long-term liabilities (loans) and relatively liquid assets (inventory) that do not lose their value quickly.[169] While banks struggle to use long-term assets like loans to offset short-term liabilities like demand deposits, commercial paper, and repurchase agreements,[170] many commercial firms have inflowing cash from the sale of their goods or services. By contrast, banks susceptible to funding shortages and "runs" may be forced to sell assets in a fire sale to meet short-term liquidity requirements.[171]

An illustrative example of this relationship is the interaction between the few bank-owning commercial firms struggling in bankruptcy and the stability of their subsidiary banks.[172] As the commercial parents slowly failed or reorganized, their banks remained healthy and were even able to count on their struggling parent as a source of strength.[173]

A commercial parent of a bank could serve as a stopgap for losses when its subsidiary bank falters. It could perform the same protective function that the Federal Reserve and the FDIC provide for failing banks. This more stable and less correlated business model could stop a financial contagion from overpowering the subsidiary bank. Thus, a

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168 Bullard et al., *supra* note 164, at 409.

169 Wallison, *supra* note 162.

170 Bullard et al., *supra* note 164, at 409.

171 *Forum to Explore the Causes of the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n* 5 (2010) (written statement of Randall Kroszner, Norman R. Bobins Professor of Economics, University of Chicago Booth School of Business), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0226-Kroszner.pdf.

172 *See* Baradaran, *supra* note 69, at 1180–82.

173 *See id.* One particularly clear example is the success of the industrial bank controlled by commercial firm Conseco, Inc., even while its parent company was experiencing bankruptcy. As the FDIC has explained,

> Despite the financial troubles of its parent and the parent's subsequent bankruptcy[,] . . . Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, $323 million of the $1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC—Conseco Bank, renamed Mill Creek Bank—which was purchased by GE Capital. As a testament to the Conseco Bank's financial health at the time of sale, the $323 million was equal to the book value of the bank at year-end 2002.

Blair, *supra* note 12, at 114 (footnotes omitted); *see also* Patrick Fitzgerald, *Lehman Seeks OK to Inject Cash to Save Banks*, AM. BANKER, Feb. 12, 2009, http://www.americanbanker.com/syndication/-372607-1.html.

commercial parent can serve as a source of strength to a struggling bank in a more effective way than a BHC.

C. *The Current Banking Model Creates Incentives for Risktaking*

The BHCA model fosters systemic risk for several reasons. As explained above, the BHCA model creates incentives for firms to grow bigger: failed banks are purchased by bigger banks, and implicit government support for banks that are too big to fail creates an incentive to grow even larger to take advantage of the capital subsidy created by the implicit guarantee.[174] Moreover, consolidation naturally increases risks because it leads to less diversity of products and players.[175] In addition, the current banking system incentivizes banks to take excessive risks and understate these risks.

Moral hazard is created any time an actor gets the benefit of profits without bearing the full risk of loss.[176] The banking industry suffers from a well-known moral hazard problem caused primarily by state support of banks.[177] This moral hazard causes banks to take risks they would not take if they bore the full risk of loss. In simplest form, a bank makes a profit by taking deposits that carry a low rate of interest and investing or loaning out these funds at a higher rate of interest.[178] Banks have an incentive to act in ways that increase the margin between the amount being paid out to depositors and the amount being collected from investments.[179] One way to do this is to invest depositor money in funds that bear more risk and have a higher yield.[180] As rational actors, banks weigh the benefits of greater risk against the potential losses.[181] However, banks do not suffer the full conse-

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174 *See supra* Part II.A; *see also* Wilmarth, *supra* note 75, at 445.

175 *See* Wilmarth, *supra* note 75, at 445.

176 Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 255–56 (2010) ("There is a fundamental, and now well-understood, moral hazard problem in banks. Those who provide equity capital have an excessive incentive to take risk. They will capture the full upside, while some of the downside will be borne by the government as insurer of deposits if the bank goes bankrupt." (footnotes omitted)); Okamoto, *supra* note 119, at 204 ("Moral hazard arises when an actor does not bear all of the consequences of his actions. It is particularly acute when he can profit by taking risks that he does not fully bear. Asset managers who profit from the gains earned using other people's money face a moral hazard.").

177 *See* Bebchuk & Spamann, *supra* note 176, at 255 n.19. State support of banks comes in many forms: asset purchase, capital and liquidity injections, debt guarantees, and deposit insurance. *See* HALDANE & ALESSANDRI, *supra* note 5, at 3–4.

178 *See* Okamoto, *supra* note 119, at 192–93.

179 *See id.*

180 *See id.* at 185.

181 *See id.*

quences of loss because the losses consist of depositors' money that is protected by the FDIC fund.[182]

This naturally leads banks to take greater risks in order to increase their profits. This structure leads to a form of the tragedy of the commons, as banks are led to take advantage of risk-laden, but highly profitable, products with little concern for externalities in the broader market. Because banks do not have direct ownership of the assets and do not suffer the long-term losses associated with too much risk, they have an incentive to exploit certain products and services.[183] Indeed, banks with "no skin in the game" are not properly incentivized to avoid risks.[184] This problem exists when the players who decide how much risk to assume are not affected by the loss.[185] Banks qualify as such players because they invest depositors' money but rarely their own.

When a failure occurs, limited liability protects bank managers, and the products are sold off to other banks without any reputational stigma attached to the portfolio or manager.[186] As a result, banks also have a weakened incentive to protect the goodwill and reputation associated with assets under their control. In addition, the events leading up to the subprime mortgage crisis demonstrate how banks can have an incentive to understate or even conceal the risk of their investments. A common practice among banks, like Washington Mutual, was to originate loans and then sell them to a CDO pool.[187] Washington Mutual created risky loans and sold them right away[188]

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182 *See* Bebchuk & Spamann, *supra* note 176, at 255–56.

183 *See, e.g.*, Schwarcz, *supra* note 163, at 387–90 (discussing how the "originate-and-distribute" model of the mortgage industry created a moral hazard that may have led mortgage originators to create excessive risk).

184 *See* Karl S. Okamoto, Point of View, *Skin in the Game*, LEGAL TIMES, Sept. 29, 2008, at 52.

185 *Id.*

186 *See* Bebchuk & Spamann, *supra* note 176, at 252. Haldane and Alessandri point out: "In the early days of banking, liability was not just unlimited; it was often as much personal as financial. In 1360, a Barcelona banker was executed in front of his failed bank, presumably as a way of discouraging generations of future bankers from excessive risk-taking." HALDANE & ALESSANDRI, *supra* note 5, at 8.

187 Okamoto, *supra* note 119, at 209; *see also* Okamoto, *supra* note 184, at 52 ("Basically, the way [CDOs] work is that a sponsor pools together a large group of mortgages or other financial assets. The sponsor then issues tranches of securities that represent a series of claims against the pool. Because of the quite legitimate magic of diversification, the pool of assets is, indeed, more valuable than the sum of its parts. The sponsor makes money by creating that magic.").

188 *Wall Street and the Financial Crisis: The Role of High Risk Home Loans: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental*

and was rewarded based on the volume of loans, regardless of the level of risk associated with the loan.[189] Therefore, "[i]t was in WaMu's interest to downplay the credit quality issues of any particular loan so long as it did not jeopardize the ability to resell the loans it was originating."[190]

Moreover, FDIC deposit insurance creates an additional moral hazard problem that is unavoidable for banks because deposit insurance does not incentivize bank customers to place their deposits in the "safest" bank. The FDIC currently insures up to $250,000 per depositor for losses due to bank failure.[191] Without the backing of FDIC insurance, depositors would have an incentive to perform careful research prior to depositing funds and would thereafter take measures to ensure prudence in investments. However, depositors who are guaranteed reimbursement for any losses due to bank failure have little or no incentive to research the bank and its investing practices, nor do they have an incentive to ensure prudent investing by those entrusted with their money.[192] Thus, a moral hazard is created as banks do not have a need or incentive to convince their customers that they are effectively managing risk.

1. *Problems with Regulation*

Because banks lack the natural incentives to avoid excessive risk in their investments and individual depositors lack the natural incentives to research banks and hold them accountable, the burden of regulation lies entirely on third parties. Regulators are outsiders of the firm and therefore have extreme difficulty understanding the risk exposure of a given bank.[193] This disadvantage is amplified as banks get bigger and, some argue, become too big to regulate.[194] Because of this informational disadvantage, regulators often struggle to create regulations that take into account all possible outcomes, and sometimes these regulations can actually lead to unexpected and devastating results.

Affairs, 111th Cong. 5–8 (2010) (statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations).

189 Okamoto, *supra* note 119, at 209.

190 *Id.*

191 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 335, 124 Stat. 1376, 1540 (2010) (to be codified at 12 U.S.C. § 1821(a)(1)(e)).

192 *Cf.* HALDANE & ALESSANDRI, *supra* note 5 (arguing that banks have an incentive to take risks and be overleveraged because of state support of banking).

193 Bebchuk & Spamann, *supra* note 176, at 281.

194 *Id.*

One example is found in the United States in the years leading up to the recent crisis. Regulators required U.S. banks to work under a regulatory leverage ratio, which means that they were limited in the amount of liabilities they could set against their assets.[195] However, because banks stood to gain a lot more profit from the upside of higher risk, they increased the riskiness of their liabilities so that they could maintain the same leverage ratios and still attempt to increase profits.[196] In order to get a higher return on equity, many banks increased the amount of risk in their asset pools by using, for example, mortgage-backed securities and then subprime mortgages that were bundled into mortgage-backed securities.[197] When these high-risk assets fell into default, the banks suffered tremendous losses.[198] Thus, although regulators were trying to force banks to reduce risk exposure, they led banks toward different types of risk that ended up causing financial devastation. The regulators could not diminish the lure of higher leverage and heightened exposure. Indeed, some scholars argue that increased bank regulation will lead to weaker banks because regulators will too often focus on mandated ratios and numbers, and miss the real risks.[199]

As discussed, banks also have an incentive to conceal risks, making it even more difficult for regulators to detect potential problems.[200] Further, banks have a greater financial incentive to discover and exploit regulations than regulators do to discover malfeasance, making banks perpetually a step ahead of regulators. If a bank finds a way to gain a competitive advantage, the result could lead to huge profits.[201] For example, if a bank could find a way to make an additional $1 billion in profit each year, it would be rational for it to spend any amount up to $1 billion to discover this method. The regulator, on the other hand, does not benefit any more for discovering the bank's bad behavior than if it were to ignore the problem, and regulatory agen-

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195 HALDANE & ALESSANDRI, *supra* note 5, at 6.

196 *See* Charles W. Calomiris, *Financial Innovation, Regulation, and Reform*, 29 CATO J. 65, 66 (2009) ("There is no doubt that the financial innovations associated with securitization and repo finance were at least in part motivated by regulatory arbitrage.").

197 HALDANE & ALESSANDRI, *supra* note 5, at 10.

198 *Id.*

199 *See, e.g.*, Okamoto, *supra* note 119, at 211 ("[H]ow do we keep ourselves safe from financial turmoil? In the end, I am not certain we can, and I am almost certain that trying too hard could be worse."); *id.* at 211 n.93 ("As Justice Breyer admonishes, '*modesty* is desirable in one's approach to regulation.'" (quoting STEPHEN BREYER, REGULATION AND ITS REFORM 184 (1982))); *see also* STEPHEN BREYER, REGULATION AND ITS REFORM 184–88 (1982).

200 *See supra* text accompanying notes 183–85.

201 *See* Okamoto, *supra* note 119, at 208–09.

cies are often insufficiently funded.[202] We should therefore expect to see a largely disproportionate amount of resources being spent on discovering and exploiting regulations compared to resources spent on preventing such behavior.[203]

2. *Commercial Firms and "Skin in the Game"*

It is easy to see how commercial ownership of banks could solve the moral hazard or "skin in the game" problem discussed above. When a commercial firm owns a bank, its assets are on the line and it is forced to internalize the downside of the bank's risks. In the past, when a commercial firm has attempted to own a bank (such as an industrial bank) through one of the limited exceptions in the BHCA, the firm has typically entered into a capital guarantee contract with the FDIC requiring the firm to pay the liabilities of the bank in the event of a failure before FDIC payout.[204] If the BHCA's requirements were relaxed, as this Article proposes, and commercial firms were allowed into banking, this type of contract would be a precursor to any ownership arrangement. Without such an agreement, commercial owners would not fare much better than BHCs that do not have assets of their own. It is this imposition of liability that causes the benefits of the commercial alliance to be realized. In addition, cross-guarantee liability could be imposed whereby all the affiliates of a given firm would also be responsible for the bank's liabilities.[205]

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202 *See* James A. Fanto, *The Role of Financial Regulation in Private Financial Firms: Risk Management and the Limitations of the Market Model*, 3 BROOK. J. CORP. FIN. & COM. L. 29, 39–40 (2008).

203 For example, in anticipation of the Volcker Rule, some firms moved their proprietary traders onto desks that trade with company clients, blurring the lines between a proprietary trade and one made on behalf of clients. Aaron Lucchetti & Jenny Strasburg, *What's a 'Prop' Trader Now?*, WALL ST. J., July 6, 2010, at C1.

204 For an example of such a contract, see Capital Maintenance and Liquidity Agreement, Parent Company Agreement, and Passivity Agreement, Marlin Bus. Bank (Proposed) (Fed. Deposit Ins. Corp. Mar. 20, 2007), http://www.fdic.gov/regulations/laws/bankdecisions/depins/MarlinAgreements.pdf.

205 This arrangement exists with BHCs, but is usually not enforceable because often the entire ship sinks at once. *See* Letter from Donald E. Powell, Chairman, Fed. Deposit. Ins. Corp., to Senator Robert F. Bennett (Apr. 30, 2003), *available* at http://www.fdic.gov/news/conferences/future_bennett.html (explaining cross-guarantee liability vis-à-vis industrial banks and traditional banks). Mandating cross-guarantee liability essentially forces the commercial parent to internalize the costs otherwise borne by the FDIC. The effect is similar to that proposed by Alan Greenspan in which he advocates requiring banks to hold bonds that automatically convert to equity when equity capital falls below a certain threshold. *See Subprime Lending and Securitization and Government Sponsored Enterprises*, *supra* note 8, at 11. The increased prices of such bonds cause the stakeholders to internalize the costs, materially reducing moral hazard. *See id.*

Forcing ownership of risk ensures that a commercial parent has "skin in the game," thus creating a natural incentive for reduced risktaking. Without the assurance of government bailouts, firms would bear a greater share of the losses if they were to fail, thereby reducing moral hazard. As Warren Buffett aptly advised in an unrelated context, firms must be forced to "eat [their] own cooking."[206]

III. Mixing Banking and Commerce

Although it is generally presumed that there is a distinct line between banking and commerce, the reality is that banking and commerce have been successfully mixed in many instances, without impairing the integrity of the bank or the commercial firm. This has been done both with FDIC-insured depository institutions and with bank-like services offered through non–FDIC-insured commercial firms.[207] Recently, private equity firms have begun to enter the banking fray through an FDIC program that encourages such firms to purchase failing banks.[208]

There are two ways a traditional commercial firm can own an FDIC-insured depository institution.[209] The first is to own a single thrift as a unitary thrift holding company.[210] Unitary thrift holding

206 Buffett recently explained one of his investments by saying: "In short, we eat our own cooking . . . no other testimonial means more." Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 12 (Feb. 26, 2010), *available at* http://www.berkshirehathaway.com/letters/2009ltr.pdf; *cf.* Mark Tier, The Winning Investment Habits of Warren Buffett & George Soros 230–32 (2005) (explaining that a good measure of an investor's confidence in his investments is how much of his own money he puts on the line).

207 *See ILC's—a Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 109th Cong. 208 (2006) (testimony of George Sutton, Esq., on behalf of the Securities Industry Association); O. Emre Ergungor & James B. Thomson, Fed. Reserve Bank of Cleveland, Industrial Loan Companies (2006), *available at* http://www.clevelandfed.org/research/Commentary/2006/1001.pdf.

208 *See* Frank Righeimer Martin, Note, *Private Equity Investment in Failed Banks: Appropriate Investors Welcome*, 14. N.C. Banking Inst. 403 (2010); Joe Adler, *PE Investors Settle for Small Slices*, Am. Banker, Apr. 14, 2010, at 13.

209 Previously there were three ways for a commercial firm to own a bank: through a One Bank Holding Company, a Unitary Thrift Holding Company, or by owning an Industrial Loan Company. *See* Larry D. Wall et al., *The Final Frontier: The Integration of Banking and Commerce, Part I: The Likely Outcome of Eliminating the Barrier*, 93 Fed. Res. Bank Atlanta Econ. Rev., no. 1, 2008 at 1, 9–11, *available at* http://www.frbatlanta.org/filelegacydocs/er08no1_wall.pdf. The One Bank Holding Company "loophole" was closed, however, by amendments to the Bank Holding Company Act in 1970. *See id.* The other two options remain. *See id.*

210 *Id.* at 11. Commercial firms that own thrifts through unitary thrift holding companies include E*Trade, H&R Block, John Deere, Macy's, Nordstrom, Raymond James, Scottrade,

companies can engage in any commercial enterprise as long as the thrift meets certain activity restrictions.[211] The second way a commercial firm can own an FDIC-insured bank is to own an industrial bank, as discussed below.[212]

Additionally, many commercial firms are increasingly engaged in bank-like services to meet the demands of their customers. Aided by the Internet and a more open financial landscape, many commercial firms have built business models based on bank-like services. PayPal, which was established at the height of the dot-com boom, is one successful example of a bank-like entity that entered and dominated a financial market previously controlled by banks. PayPal is not a bank and is not controlled by banking regulators, but for its more than 94 million customers, it provides bank-like services.[213] PayPal allows small traders to receive credit card payments or money wires and serves as a repository for deposits by buyers. Money in the account can be withdrawn in a variety of ways. PayPal is a fast-growing company operating in almost 200 markets worldwide with yearly revenue of $3.4 billion.[214]

Technological innovation has led many commercial firms to more holistically serve their customers, who increasingly demand financing services. Even without the benefit of deposits or FDIC insurance, some commercial firms engage in lending activities either as an additional revenue source or as a complementary service to boost sales of existing products. These firms have found that in order to stay profitable and fully service their customers, they need to offer financial ser-

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State Farm, T. Rowe Price, Allstate, and Edward Jones. *See Holding Company Search*, OFF. COMPTROLLER CURRENCY, http://www.ots.treas.gov/?p=HoldingCompanySearch (last visited Nov. 19, 2011) (under "Bank Type" pull-down menu, select "Stock HC Owning Only Thrift(s)"). Nordstrom converted its credit card bank into a federal savings bank in 2000 to offer a wider variety of payment options to its customers. Robert T. Nelson, *Nordstrom Establishes Federal Savings Bank*, SEATTLE TIMES, Mar. 3, 2000, at C2.

211 The most important restriction is the Qualified Thrift Lender Test, which basically requires that approximately sixty-five percent of the thrift be dedicated to home- or mortgage-related lending. *See Historical Framework for Regulation of Activities of Unitary Savings and Loan Holding Companies*, OFF. THRIFT SUPERVISION, http://files.ots.treas.gov/48035.html (last visited Nov. 19, 2011). Other restrictions are meant to ensure that the commercial firm does not "unduly exploit the subsidiary thrift," and include restrictions on transactions with affiliates, loans to one borrower, anti-tying restrictions, restrictions on sales of securities, etc. *See id.*

212 *See* Wall et al., *supra* note 209, at 9.

213 *See Corporate Fast Facts*, PAYPAL, http://206.200.251.32/documentdisplay.cfm?DocumentID=2260 (last visited Nov. 19, 2011).

214 *See id.* Paypal is owned by eBay and contributes thirty-nine percent of eBay's annual revenue. *Id.*

vices without a middleman.[215] UPS, for example, offers its clients a variety of services, including shipping and packaging of merchandise, as well as financing services.[216] In 1998, UPS started UPS Capital to provide asset-based lending and factoring to some of its commercial clients.[217] Today it offers a wide range of supply chain financing options, small-business lending, cargo insurance, and other financial services.[218]

Other institutions are also offering services that initially belonged to banks.[219] Volkswagen entered the banking market with Volkswagen Bank USA and offers services and products such as savings accounts, home-equity lines of credit, auto financing, credit cards, and checking accounts.[220] The Money Centers at Wal-Mart, which are specifically targeted at Wal-Mart customers who do not have bank accounts, offer a variety of services including check cashing, international money transfers, and money orders.[221] Retailers, such as 7-Eleven[222] and Nordstrom, and even universities, such as Drexel University, offer various banking services.[223] Similarly, IBM Global Financing, Hewlett-Packard Financial Services, and Dell Financial Services each offer financing for businesses looking to upgrade their technology.[224] Caterpillar Financial offers direct financing and insurance products for its equipment purchasers.[225]

The prevalence of these banking and commerce alliances speaks both to the need for them in the marketplace as well as their commercial success. Many commercial firms engage in financing to increase profits and efficiency. Most of these commercially operated "banks"

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215 *See generally* THOMAS L. FRIEDMAN, THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY 441–74 (3d ed. 2007) (explaining the changing landscape of worldwide business and the need to adapt to stay competitive).

216 Helen Stock, *UPS Hopes Loans Deliver Customers*, AM. BANKER, Nov. 17, 2000, at 1.

217 *Id.*; *see* Baradaran, *supra* note 69, at 1193.

218 *See* David Breitkopf, *UPS, With Newly Added Bank, Makes Top 10 in SBA Loans*, AM. BANKER, Nov. 15, 2001, at 1; *Products & Services*, UPS CAPITAL N. AM., http://capital.ups.com/solutions/ (last visited Nov. 19, 2011).

219 Pekarek & Huth, *supra* note 94, at 633.

220 *Id.*

221 Wendy Zellner, *Your New Banker?*, BUSINESSWEEK, Feb. 7, 2005, at 28.

222 *Id.*

223 Pekarek & Huth, *supra* note 94, at 635.

224 DELL FIN. SERVICES, http://dfs.us.dell.com/Pages/DFShomepage.aspx (last visited Nov. 19, 2011); IBM GLOBAL FINANCING, http://www.ibm.com/financing/us/index.html (last visited Nov. 19, 2011); *Leasing & Financing*, HP, http://www8.hp.com/us/en/hp-financial-services/solutions/leasing.html (last visited Nov. 19, 2011).

225 *Financing & Insurance*, CAT FIN., http://finance.cat.com/cda/layout?m=943078x=7 (last visited Nov. 19, 2011).

function outside of the BHC structure and demonstrate that the separation of banking and commerce in commerce runs counter to the demands of the modern market. The trend in modern business is toward diversity of products and increased inclusion of financial services. The forced separation of commercial firms from banks does not seem sustainable in the increasingly integrated marketplace.

A. *Industrial Banks*

The industrial bank has survived for thirty years outside the scope of the BHCA. This form of financial institution came under intense scrutiny due to Wal-Mart's infamous application and was the subject of a House and Senate bill aimed at its termination.[226] Although the controversy subsided after Wal-Mart withdrew its application, the charter is still seen as dangerous in some sectors, and the calls for its elimination have not abated.[227] Even Dodd-Frank addresses industrial banks by imposing a moratorium on new charters and commissioning a U.S. Government Accountability Office ("GAO") report on the safety of the charter.[228] Congress passed on the opportunity to ban the charter in 2007, but it may confront the issue of industrial banks again in the near future. Ironically, hidden in an afterthought to financial reform is a valuable example of a successful alliance of banking and commerce that demonstrates the stability of commercially owned banks in contrast to traditional BHCs.

Companies with industrial banks include GE, BMW, Toyota, Pitney Bowes, Harley-Davidson, and Target.[229] Industrial banks have been eligible for FDIC insurance since 1982 by virtue of provisions that distinguish them from traditional retail banks.[230] Many of the major auto manufacturers use industrial banks to offer financing options

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226 *See* Dash, *supra* note 2; *see also* Industrial Bank Holding Company Act of 2007, H.R. 698, 110th Cong. (2007).

227 *See* Silla Brush, *Manufacturing Giants Aim to Protect Industrial Banks*, HILL (Apr. 12, 2010, 7:00 PM ET), http://thehill.com/business-a-lobbying/91793-manufacturing-giants-aim-to-protect-industrial-banks (discussing various interests' positions regarding the ongoing industrial bank debate).

228 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 603, 124 Stat. 1376, 1597–99 (2010) (to be codified at 18 U.S.C. 1815 note).

229 *Financial Reports of Industrial Loan Companies*, IBANKNET, http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=ilc (last visited Nov. 19, 2011); *see also* Baradaran, *supra* note 69, at 1189.

230 Pursuant to CEBA, an industrial bank is not a "bank" for purposes of the BHCA if it meets one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100 million, or (3) a company has not acquired control of the institution after August 10, 1987. 12 U.S.C. § 1841(c)(2)(H)(i) (2006); *see also* Johnson & Kaufman, *supra* note 71, at 41.

to purchasers and dealers of their automobiles.[231] Commercial giant GE offers a wide variety of financial services through GE Capital including commercial lending and leasing, consumer financing, and real estate financing.[232] GE Money Bank also issues many private label retail credit cards, including for stores such as J.C. Penney and Wal-Mart.[233] Owning an industrial bank gives a commercial firm access to FDIC-insured deposits while enabling it to offer a wide array of financial products to its customers.

The experience in the industrial bank sector has been instructive. Industrial banks are one of the only types of banks that can be owned and operated by commercial firms.[234] They are primarily found in the state of Utah and have been operating successfully for several decades.[235] To date, no commercially owned industrial bank failure in Utah has caused any amount of loss to the FDIC insurance fund.[236] According to various industry measures, Utah industrial banks are among the healthiest banks in the country.[237] The Appendix includes an analysis of banking figures as of September 30, 2010, for state-chartered banks across the United States. The data illustrate that industrial banks have higher capital-to-asset ratios, better quality assets, and more efficient earnings on average than other banks.[238] Commercially owned industrial banks have a healthier risk profile than their noncommercially owned counterparts according to bank health measures commonly used by the FDIC.[239] Although several of the Utah industrial banks lost money in 2008 and 2009, they remain well capitalized overall and have good asset quality.[240]

Utah regulators and industrial bank supporters attribute this success to the vigilant regulatory structure that surrounds the firms as

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231 *See* Johnson & Kaufman, *supra* note 71, at 42–43.

232 *See* GE CAPITAL, http://www.gecapital.com/en/index.html (last visited Nov. 19, 2011).

233 *See J. C. Penney Corporation, Inc. Privacy Policy*, JCPENNEY, http://www.jcpenney.com/jcp/CustomerServiceSub.aspx?CatTyp=CSR&CatID=12490 (last updated Apr. 5, 2011); *Walmart Money Center: Walmart Credit Cards*, WALMART, http://www.walmart.com/cp/Credit-Card-Benefits/435440 (last visited Nov. 19, 2011).

234 For a thorough analysis of Industrial Banks, see Baradaran, *supra* note 69, at 1144–51.

235 *Id.* at 1145–46.

236 *H.R. 698, the Industrial Bank Holding Company Act of 2007: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 157 (Apr. 25, 2007) [hereinafter *H.R. 698 Hearing*] (testimony of G. Edward Leary, Utah Comm'r of Financial Institutions).

237 *See infra* Appendix.

238 *See infra* Appendix (comparing the capital ratios of Utah commercially owned industrial banks to traditional commercial banks as of the third quarter of 2010). FDIC and Utah state-regulator statistics are on file with author. A chart is provided in the Appendix.

239 *See infra* Appendix.

240 *See infra* Appendix; Lipton, *supra* note 127.

well as the support these banks receive from well-funded parent companies. Utah regulators report that in several instances, an industrial bank in trouble has quickly received a much-needed capital infusion from its parent.[241] Even when a parent such as GM is suffering from its own capital weaknesses, it has been able to offer assistance to its subsidiary, GMAC.[242] This relationship is possible because of the diversity of assets and operations between the parent and the banking subsidiary.

This easy access to capital cannot be understated, as it is the most important factor for bank safety. An industrial bank also benefits from its business relationship with the parent. There are few marketing costs associated with industrial banks because their business is often handed to them by their parent companies. Most parents organize industrial banks to add value to an existing business; as a result, they begin as a profitable enterprise with few startup costs and pitfalls.[243] Most traditional banks only achieve this level of security and efficacy after many years in operation.[244]

B. Arguments Against Mixing Banking and Commerce

The arguments against mixing banking with commerce at the bank-ownership level fall into three categories: (1) keeping banking and commerce separate has been the policy for a long time in this country, has gained strength over time, and should continue; (2) banking regulators do not have the authority to effectively supervise parent companies; and (3) mixing banking and commerce produces systemic risk, which endangers the safety and soundness of the banking system.

First is the argument that the policy of keeping banking and commerce separate has been generally followed since 1787 and has gained strength over time through legislation.[245] However, as already noted, scholars who have described the history of separation have often conflated the separation of banking and commerce in banking and the separation of banking and commerce in commerce when advocating continued separation.[246] Those that argue that the separation of banking and commerce is part of the American tradition do not accurately

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241 Telephone Interview with George Sutton, Partner, Jones Waldo Law Firm (Jan. 7, 2009).

242 Telephone Interview with Darryle Rude, Supervisor of Indus. Banks for the State of Utah (Jan. 28, 2009).

243 *ILC's—a Review of Charter, Ownership, and Supervision Issues*, *supra* note 207, at 207 (testimony of George Sutton, Esq., on behalf of the Securities Industry Association).

244 *Id.*

245 *See* Symons, *supra* note 21, at 685–89; Wilmarth, *Wal-Mart*, *supra* note 14, at 1554.

246 *See supra* text accompanying note 13.

depict the realities of early banks or historical ties between banking and commerce.[247] Many of the early bank charters were controlled by industrialists who used their banks to support their commercial activities.[248]

Second is the argument that banking regulators lack the authority to exercise adequate supervision over commercial parents of subsidiary banks.[249] Some argue that without federal consolidated supervision[250] of bank parent companies, the financial system is less stable[251] and the parent company is more prone to risk.[252] Federal consolidated supervision is meant to catch weaknesses in a BHC before they pose a threat.[253] In contrast to federal consolidated supervision, the FDIC is limited in the scope of its supervision and the extent to which it can

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247 *H.R. 698 Hearing*, *supra* note 236, at 122 (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System) ("If left unchecked, this recent and potential future growth of firms operating under the [industrial bank] exception threatens to undermine the decisions that Congress has made concerning the separation of banking and commerce in the American economy . . . .").

248 The Bank of the Manhattan Company was formed by the Manhattan Company, which was created to provide New York City with safe water. *See* OFFICE OF RESEARCH & STRATEGIC PLANNING, *supra* note 32, at 24. The bank became the largest in the city as well as in the state, and survives today as Chase Manhattan Bank. *See id.* Additionally,

> [i]n the nineteenth century, for example, Moses Taylor owned controlling interests in the National City Bank (a forerunner of Citibank) . . . [and] owned controlling interests in a mercantile house, a gas utility and an iron company. Thomas Mellon started a private bank in Pittsburgh in the mid-nineteenth century and by the turn of the century the Mellon family owned controlling interests in Mellon National Bank, Gulf Oil, Alcoa Aluminum, and various other industrial enterprises.

Haubrich & Santos, *supra* note 17, at 155. For additional examples of investors that have had controlling interests in both banks and commercial firms simultaneously, see Thomas F. Huertas, *Can Banking and Commerce Mix?*, 7 CATO J. 743, 744 (1988).

249 *See H.R. 698 Hearing*, *supra* note 236, at 131 (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System); Wilmarth, *Wal-Mart*, *supra* note 14, at 1613–17.

250 Federal consolidated supervision is "a comprehensive approach to banking supervision which endeavors to evaluate the strength of an entire group, taking into account all the risks which may affect a bank (or individual regulated firms within the group), regardless of whether these risks are carried in the books of the bank or related entities." WORK GROUP NO. 3, ASS'N OF SUPERVISORS OF BANKS OF THE AMS., CONSOLIDATED SUPERVISION 15 (2008), *available at* http://www.asbaweb.org/Grupos/libros/fscommand/doc7.pdf.

251 *See* Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5217–18, 5221–23 (proposed Feb. 5, 2007) (to be codified at 12 C.F.R. pt. 354) (justifying proposed regulations in part on this ground); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-621, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 27–28, 33–34, 79–80 (2005) (noting these concerns), *available at* http://www.gao.gov/new.items/d05621.pdf.

252 *See H.R. 698 Hearing*, *supra* note 236, at 122, 133–34 (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System).

253 *Id.* at 131–32.

examine a commercial parent of a bank.[254] The regulator cannot impose capital requirements on parent companies and has limited authority to bring administrative proceedings against parent companies and affiliates.[255] Some also argue that the FDIC does not have the expertise to identify or control risk in a commercial firm.[256]

However, as demonstrated by the recent crisis, there is no monopoly of regulatory expertise when it comes to bank regulation. Most of the banking regulators have been criticized for not detecting and addressing the failures in the financial system.[257] The problems with regulation discussed above affect the regulators equally. Dodd-Frank was a recognition by Congress that many of the regulatory agencies were doing duplicative work (which resulted in inefficiencies) and that collectively, they missed the warning signs that they were tasked to address.[258]

Many of the commercial firms that would own banks are regulated by the Securities and Exchange Commission ("SEC"), and their subsidiary banks are regulated by the FDIC.[259] These two regulators have the opportunity to detect risk in these companies and communicate the risk to each other. In addition, the FDIC has broad powers to issue cease and desist orders to parent companies of industrial banks that the FDIC views as endangering the companies' subsidiaries.[260] If commercial firms are allowed to own banks, the FDIC would need to retain the power to oversee a commercial parent's activities that may

254 "The FDIC may examine an 'affiliate' . . . 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].'" Wilmarth, *Wal-Mart*, *supra* note 14, at 1613 (alterations in original) (quoting 12 U.S.C. § 1820(b)(4)(A) (2006)).

255 *Id.* at 1614.

256 *Id.* at 1617. It has likewise been argued that this authority should not be granted because it would greatly expand the government's supervisory role in the general economy, and this would increase the likelihood that firms would grow large enough to be "too big to discipline" and end up capturing the agency regulating them. *Id.* at 1617–21.

257 *See, e.g.*, Floyd Norris, *Failing Upward at the Fed*, N.Y. TIMES, Feb. 27, 2009, at B1 ("But it was not all [the banks'] fault. These were regulated institutions, and the regulators failed."). For a general discussion of how banking regulation played a direct role in fomenting the recent crisis, see Calomiris, *supra* note 196, at 65–74.

258 *See* Daniel Hemel, Note, *Regulatory Consolidation and Cross-Border Coordination: Challenging the Conventional Wisdom*, 28 YALE J. ON REG. 213, 214–15 & n.2 (2011) ("[T]he Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed in July 2010, folded the [Office of Thrift Supervision] into the [Office of the Comptroller of Currency] and further centralized supervisory responsibilities in a new Financial Stability Oversight Council chaired by the Secretary of the Treasury." (footnotes omitted)).

259 *See* 12 U.S.C. § 1814(a)(1) (subjecting banks to FDIC regulation); 15 U.S.C. § 78*l* (2006) (imposing registration requirements on issuers of exchange-traded securities).

260 12 U.S.C. § 1818(b).

cause harm to a banking subsidiary. At least in the industrial bank sector, the FDIC and state regulators have had great success in regulating commercial parents of banks.[261]

The final argument against mixing banking and commerce is the most important one because it encompasses the other arguments and because the safety and soundness of the banking sector is the first priority in regulation.[262] But if allowing commercial firms to own banks would compromise safety and soundness, then such ownership should be discouraged. There are several facets to this argument that are dealt with below. First, some argue that allowing commercial firms to own banks would expose banks to risks inherent in commerce while extending the federal safety net to the commercial sector.[263] In other words, a banking subsidiary would be vulnerable to all of the business risks associated with its commercial owner. For example, if a bank were owned by a firm that is less financially stable than Wal-Mart, the company's business risk would spread to its bank, threatening its safety and soundness. This situation, while part of a typical cyclical market, would be especially troubling with a bank because the bank is supported by the FDIC fund and the fund would serve as a subsidy to a risky commercial venture. In addition, the bank's assets might also be used fraudulently to support a failing parent.

This scenario is indeed troubling, but it is not purely hypothetical. Several commercial parents of industrial loan companies ("ILCs") have failed in the past without causing any harm to the FDIC fund.[264]

261 *See, e.g.*, Press Release, Fed. Deposit Ins. Corp., FDIC Issues Cease and Desist Order Against Fremont Investment & Loan, Brea, California, and its Parents (Mar. 7, 2007), *available at* http://www.fdic.gov/news/news/press/2007/pr07022.html (providing an example where the FDIC issued a cease and desist order against Fremont Investment and Loan, Brea, California, and its parents).

262 *See* Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 673 (2010) (stating that the central focus of banking regulation is to reduce systemic risk).

263 *See* Wilmarth, *Wal-Mart*, *supra* note 14, at 1589–93, 1606–13. This argument assumes that commercial firms and commercial activities are inherently more risky than banking, but this argument has been challenged by scholars and recent history. *See, e.g.*, HALDANE & ALESSANDRI, *supra* note 5, at 5 (arguing that banks have an incentive to take risks and be overleveraged because of the banking of the state). Others also argue that commercially owned banks and industrial banks are subject to additional risks when owned by a commercial company because the risk of a troubled commercial parent is often attributed to the bank itself. *See* Wilmarth, *Wal-Mart*, *supra* note 14, at 1606–07. If the parent company defaults on its bonds or shows other signs of distress, it can spark a bank run. *Id.*

264 The following commercial parents have declared bankruptcy without causing a failure to their subsidiary banks: Tyco, Conesco, Lehman Brothers, and Flying J. *See* Baradaran, *supra* note 69, at 1181.

In the ILC experience, a commercial parent's failure has not been a fatal blow to its bank. Even after Lehman Brothers' swift and complete failure—the largest U.S. bankruptcy filing in history—its subsidiary banks have survived, though not without struggle, and are currently being prepared for sale.[265]

However, there is a cautionary tale of hubris in GM's ILC, GMAC. Founded in 1919, General Motors Acceptance Corporation served as General Motors' financing arm until GM sold a majority interest in 2006.[266] GMAC was profitable for the first 85 years of its existence, peaking at $2.9 billion in net income in 2004.[267] In 2004, GMAC purchased a Utah ILC, which became GMAC Automotive Bank, to go along with GMAC Commercial Mortgage Bank—another Utah ILC.[268] As of 2007, GMAC Automotive Bank held nearly $20 billion in assets, making it the fifth largest ILC by asset size in the country.[269] GMAC initially relied on its ILC to underwrite auto leases and loans, but quickly became dominated by mortgage lending, which accounted for the vast majority of the ILC's loans; as of 2007, $13 billion of the ILC's $16 billion in total loans were in residential mortgages.[270] Other auto manufacturers have owned or currently own ILCs,[271] but none were involved in subprime mortgage lending to the

265 Aurora Bank FSB, formerly known as Lehman Brothers Bank, and Woodlands Commercial Bank—a Utah industrial bank—were not part of the bankruptcy filing. Regulators have restricted both banks' ability to offer new certificates of deposit due to struggles to meet capital requirements, but Lehman hopes to sell the banks—valued at a combined $1.42 billion—to pay off creditors. *Lehman Preps Bank Units for Sale or Shutdown*, REUTERS (Sept. 2, 2010, 9:37 AM), http://www.reuters.com/article/2010/09/02/us-lehmanbrothers-idUSTRE68118V20100902.

266 Bill Bowman, *General Motors Acceptance Corporation (GMAC)*, GM HERITAGE CENTER, http://history.gmheritagecenter.com/wiki/index.php/General_Motors_Acceptance_Corporation_(GMAC) (last visited Nov. 20, 2011).

267 *See* Lee Hawkins, Jr., *GMAC Hopes to Shed 'Junk' Baggage: Pending Cerberus Deal Could Boost Credit Rating, Helping Current Parent GM*, WALL ST. J., May 12, 2006, at C3.

268 Johnson & Kaufman, *supra* note 71, at 42; Kenneth Spong & Eric Robbins, *Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate*, FED. RES. BANK KAN. CITY ECON. REV., Fourth Quarter 2007, at 41, 52.

269 Spong & Robbins, *supra* note 268, at 47, 51.

270 *Id.* at 52.

271 For example, Volkswagen Bank USA, BMW Bank, and Eaglemark Savings Bank, which is owned and operated by Harley-Davidson, all serve functions for their parent companies similar to the function GMAC Bank serves for GM. *Id.* at 51. This reflects the belief within the auto industry that access to credit is necessary to survive economic downturns and to maintain market share in the United States. *See* Sharon Terlep, *GM Again Sees Need for GMAC*, WALL ST. J., Jan. 11, 2011, at B1. Reliance on outside sources of credit for consumer lending and dealer financing could further expose a manufacturer to economic downturns. *Id.*

extent that GMAC was.[272] Naturally, GMAC Automotive Bank suffered when the subprime market collapsed.

Until the subprime market collapsed, GMAC had been consistently profitable for GM—accounting for eighty percent of GM's profits in 2004.[273] However, GM encountered financial difficulties as the economy declined. In 2005, GM reported losses in excess of $10 billion, resulting in the downgrading of GM's credit ratings to junk-bond status.[274] Amidst significant concerns that GM's rating would impact GMAC's rating, and in an effort to distance GMAC from GM and to finance GM's restructuring, GM sold a majority interest in GMAC, along with its ILC, to an investment group led by Cerberus Capital Investments.[275] GMAC still remained the primary financing arm for GM even after the sale. In 2008, however, GMAC "dramatically restrict[ed] leasing amid the U.S. financial crisis," causing GM to spiral toward bankruptcy.[276] Only intervention from the federal government in the form of a multibillion-dollar bailout saved both GM and GMAC (now Ally Financial) from failure.[277]

One of the greatest problems with GMAC was that the mortgage-financing operation grew to be too dominant a part of the business. A potentially problematic scenario in the commercially owned banking structure would be if the bank grew to a size that rivaled the parent or even dwarfed the parent. In other words, a small commercial firm should not be the parent of a large bank because the commercial parent could not be a source of strength if the bank were to run into problems. In fact, a small, weak parent would be similar to the traditional BHC structure with parent companies that are a shell without any independent revenue.[278] However, it would be more troubling with a commercial parent because if the FDIC fund were used to rescue a bank, the taxpayer funds could possibly make their way into the parent's coffers.[279] In this situation, the tail would be wagging the dog and the bank would not have a stable parent that could support it.

272 Conor Dougherty, et al., *Subprime Pullback May Crimp Consumer Spending*, WALL ST. J., Apr. 2, 2007, at A2.

273 Lauren Etter, *Is General Motors Unraveling?*, WALL ST. J., Apr. 8, 2006, at A7.

274 *Id.*

275 *Id.*

276 Terlep, *supra* note 271.

277 Ally received $17.2 billion, *id.*, while GM received $50 billion, Sharon Terlep, *GM Chief to Pay for Chartered Flight to D.C.*, WALL ST. J., Apr. 21, 2010, http://online.wsj.com/article/SB10001424052748704448304575197002653739926.html.

278 Baradaran, *supra* note 69, at 1189.

279 *Id.*

It is also possible that a commercial firm could be a source of weakness. A commercial parent might not be able to come to the aid of a troubled subsidiary, or the commercial parent's weakness might even push the subsidiary bank to collapse. This possibility would also need to be addressed by targeted regulation. There are several barriers already included in the BHCA—such as sections 23A and 23B—that are designed to prevent transactions between affiliates.[280] A recent study shows, however, that these barriers have not been effectively enforced in the past.[281] Regulators would need to be vigilant in addressing such breaches and detecting others. However, there is no indication that these sections would more easily be breached with a commercial parent than with the existing structure of banks and their affiliates.

In addition, there is a risk that commercial parents or their subsidiaries would become TBTF, in which case the government would be forced to step in to save them.[282] This assurance would effectively subsidize large commercial firms[283] and extend the safety net to entities that are unsupervised by banking authorities.[284] This unfair advantage could encourage conglomeration, thereby concentrating

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280 Sections 23A and 23B of the Federal Reserve Act limit transactions between Federal Reserve–member banks and their affiliates. 12 U.S.C. §§ 371c, 371c-1 (2006); *see also* Transactions Between Member Banks and Their Affiliates (Regulation W), 12 C.F.R. § 223.1 (2010) (implementing the statutory limitations).

281 Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683 (2011).

282 A scenario often presented considers if Enron had an industrial bank. *See, e.g.*, Emil Lee, *First Bank of Wal-Mart?*, MOTLEY FOOL (Nov. 20, 2006), http://www.fool.com/investing/value/2006/11/20/first-bank-of-walmart.aspx; *see also* Wilmarth, *Wal-Mart*, *supra* note 14, at 1592–93. *See generally Consideration of Regulatory Reform Proposals: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 108th Cong. 335–58 (2004) (testimony of Ed Mierzwinski, Dir. of Consumer Protection, United States Public Interest Research Group & Margot Saunders, Managing Attorney, National Consumer Law Center).

283 Wilmarth, *Wal-Mart*, *supra* note 14, at 1590–91.

284 *See* H.R. REP. No. 110-155, at 10 (2007); *ILC's—a Review of Charter, Ownership, and Supervision Issues*, *supra* note 207, at 150 (statement of Douglas H. Jones, Acting General Counsel, Federal Deposit Insurance Corporation). It is further argued that this would lead to unfair competition as large firms could use this consequent funding advantage through generous dividends, preferential loans (to affiliates and suppliers), or by transferring riskier assets to the subsidiary bank's balance sheet. Wilmarth, *Wal-Mart*, *supra* note 14, at 1594–95; *see also H.R. 698 Hearing*, *supra* note 236, at 128 (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System).

economic power,[285] and increase the risk of monopolies,[286] predatory pricing,[287] and other anticompetitive activities.[288]

There are also potential problems with fraudulent conveyances between the parent and the subsidiary. Sections 23A and 23B prevent affiliate transactions within banks and are designed to prevent any affiliate transactions between a parent and its subsidiary. However, as already mentioned, during the recent financial crisis, regulators in whose discretion it fell to enforce compliance with these limits often failed to do so.[289] Thus, these relaxed standards during times of crisis would endanger safety and soundness if a commercial parent were tacitly permitted to reach into the bank's coffers or vice versa.

Because banking and commerce have been separated for many years while the banking system has undergone a dramatic change, there is little empirical data that can demonstrate the effects of such alliances on the banking system as a whole. The best indicators of the potential success of commercial-banking alliances are industrial banks, which have remained robust and sound despite widespread banking collapse. Industrial banks have succeeded not in spite of but *because of* their well-funded commercial parents.[290]

In the absence of data that justify the separation of banking and commerce in commerce, both the success of industrial banks as well as

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285 Cantwell F. Muckenfuss III & Robert C. Eager, *The Separation of Banking and Commerce Revisited*, *in* THE MIXING OF BANKING AND COMMERCE: THE 43RD ANNUAL CONFERENCE ON BANK STRUCTURE AND COMPETITION 39, 51–52 (2007) (citing *ILC's—a Review of Charter, Ownership, and Supervision Issues*, *supra* note 207, at 132 (statement of Richard J. Hillman, Managing Director, Financial Markets and Community Investment, General Accountability Office)); *see also H.R. 698 Hearing*, *supra* note 236, at 128 (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System) ("Congress expressed concern that allowing banks and commercial firms to affiliate with each other could lead to the concentration of economic power in a few very large conglomerates.").

286 *See* Terry J. Jorde, President and CEO, CountryBank USA, Address at the Federal Deposit Insurance Corporation Symposium: The Future of Banking: The Structure and Role of Commercial Affiliations (July 16, 2003), *available at* http://www.fdic.gov/news/conferences/future_jordespeech.html.

287 *H.R. 698 Hearing*, *supra* note 236, at 104–05 (statement of James P. Ghiglieri, Jr., President, Alpha Community Bank; Chairman, Independent Community Bankers of America).

288 Jorde, *supra* note 286.

289 Omarova, *supra* note 281.

290 Baradaran, *supra* note 69, at 1195. In addition, a recent study analyzed commercial and banking interactions at the entity level—in other words, not with respect to banks engaging in commercial activity, but with respect to banks interacting with commercial firms. Feibelman, *supra* note 26, at 974. The study found that there are benefits when banks are involved with their corporate debtors in the commercial lending context. *Id.* The author concludes that these positive interactions with banks and corporations suggest that the rationale for the separation of banking and commerce may not apply to all contexts. *Id.*

the inherent risks in the current banking model described above demonstrate that there is potential for commercially owned banks to provide safety in banking. Commercial ownership of banks might be one way to counteract incentives toward risktaking by forcing some parent companies to internalize their risks.

1. *Should the Exception Become the Rule?*

Is it misleading to use the success of an exception, the industrial bank, to question the structure of traditional banks? Just because a Wal-Mart bank would prove sound, should we allow the full range of commercial firms to operate banks? Or are banks such as GE Capital misleading examples because their parents are so large and well funded? Perhaps if the ILC model is exported broadly, it would fail and prove that the exception only works in small numbers that are vigilantly guarded by regulators. As discussed, there are several risks and pitfalls in commercial ownership of banks, and regulators would have to appropriately monitor these potential hazards.

What about the criticisms of bank regulation discussed above? It seems disingenuous to state on the one hand that regulators are not capable of regulating bank safety, as this Article has repeatedly done, and suggest on the other hand that if commercial firms were allowed to own banks, that these very regulators would need to be entrusted with keeping the system intact. Regulators have greater difficulty enforcing rules that run against strong natural incentives and are better able to monitor businesses that themselves have a natural incentive toward decreased risktaking. For example, regulators have great difficulty enforcing vague standards of riskiness, but do not have difficulty when it comes to enforcing black-and-white rules such as capital adequacy requirements or product limits. Regulators can adequately monitor businesses to guard against fraud and self dealing or enforce bright line rules.[291]

For commercially owned banks, regulation would have to address the size of the bank vis-à-vis the commercial parent to ensure that the commercial parent is larger and better funded than a bank, and that a bank is being used to service the commercial firm as opposed to the

291 *See* Raghuram Rajan, *Rajan Roundtable: A Response from the Author*, ECONOMIST (Apr. 15, 2009, 1:00 PM), http://www.economist.com/blogs/freeexchange/2009/04/rajan_roundtable_a_response_fr (arguing that "regulators rarely have the political or intellectual independence to exercise discretion" and that they are best served when they have defined rules to follow). *See generally* Shahien Nasiripour, *Geithner Stresses Need for 'Clear Rules' for Wall Street, But Senate Bill Doesn't Have Them*, HUFFINGTON POST, Apr. 21, 2010, http://www.huffingtonpost.com/2010/04/21/geithner-stresses-need-fo_n_545281.html.

other way around. Regulators would need to ensure that the bank did not become so large as to be the dominant entity in the corporation. Most commercial firms that currently own banks use them as a means to support their business and not vice versa.[292]

2. *Can Regulators Monitor Nonbanking Businesses?*

Another concern is whether banking regulators can adequately monitor risks associated with a commercial firm. This argument asserts that although the FDIC and other banking regulators may have developed expertise in identifying risky behavior in banks, they are not trained in assessing risks in commercial entities.[293] This argument assumes, however, that the same regulator would need to monitor both businesses, or that it is necessary for a regulator of a banking subsidiary to also regulate a parent company. In reality, there are many organizational structures in which different regulators oversee different branches of a business.[294] A banking regulator can regulate a subsidiary bank and assure that the bank's operations do not violate imposed limits, while a commercial regulator can oversee a parent firm.

Regulators of ILCs operate in this manner and have successfully provided adequate oversight to the banks while communicating with the parent company's regulator when the need has arisen.[295] It is also a misconception that the same people who manage the company manage its bank.[296] In the industrial bank sector, the banks are often run by experienced bank managers with little control exerted over day-to-day operations by commercial management.

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292 *See supra* Part III.A.

293 Wilmarth, *Wal-Mart*, *supra* note 14, at 1613, 1617–18.

294 Banks themselves provide a good example of this, with the FDIC, among other state and federal agencies, regulating traditional "banking" activities and the SEC regulating banks' investment activities. *Cf.* Tamar Frankel, *The Dual State-Federal Regulation of Financial Institutions—a Policy Proposal*, 53 BROOK. L. REV. 53, 54–55 (1987) (identifying the various federal agencies that regulate banks).

295 12 U.S.C. § 1820(b)(4) (2006) empowers the FDIC to examine any affiliate of an industrial bank to determine the relationship between the industrial bank and its parent, and the effect of such relationship on the industrial bank. Utah, California, and Nevada also have direct authority to conduct examinations of parents and affiliates. *See The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html (last updated June 25, 2004).

296 Utah, for example, gives "considerable weight" in reviewing an industrial bank charter application to whether managers of industrial banks have extensive bank management experience, and requires that a majority of the industrial bank's board of directors be made up of independent members. *See What is an Industrial Bank?*, UTAH.GOV, http://www.dfi.utah.gov/whatisIB.htm (last visited Oct. 30, 2011).

3. *Excessive Power?*

One of the initially stated reasons for the separation of banking and commerce was the fear of excessive power in Transamerica. Given Wal-Mart's controversial practices in the past,[297] it is reasonable to be wary of a Wal-Mart national bank and fearful that it could drive many smaller banks out of business. If the ILC exception were maintained or expanded, it is possible that large commercial firms would be given a competitive advantage over small banks and dominate banking. This conglomeration of banking is a significant threat that regulations have been fighting since the earliest days of banking. It has always been believed that a healthy banking system needs to be a competitive market.

As discussed above, however, banking is more conglomerated now than ever. Most national banking chains are much larger than ever before and continue to grow.[298] Perhaps commercial firms entering into banking could curb this rapid expansion of the largest banks and dilute their power. However, there would be a risk that these commercially owned banks would continue to grow and steadily take over the market. Based on experience with ILCs, most firms that have owned banks are not interested in national branch banking. They have gained the most profit and advantage from their banks by servicing their in-house credit needs and branching locally. Many large companies have owned banks for generations without any damage to competing small banks.[299]

The BHCA was passed due to fears of excess power, and those who advocate for the separation of banking and commerce in commerce continue to express these fears. However, modern trends in banking do not support this apprehension. To the contrary, it is today's large BHCs that are continually expanding and gaining market share. And what makes these conglomerates more dangerous than commercially owned banks is that they are supported by the federal government, which causes moral hazards, and in the event of failure, can inflict serious systemic damage.

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297 Tom Bliley, *GLB Was Not an Invitation to Wal-Mart*, AM. BANKER, Jan. 27, 2006, at 17 (discussing Wal-Mart's history of driving local retailers out of business, and the "disastrous" consequences that would follow if that were to happen in banking).

298 *Supra* Part I.A.

299 Target, GE, and many automakers already own industrial bank banks. *See Financial Reports of Industrial Loan Companies*, *supra* note 229.

Conclusion

The banking structure of the United States has two inherent problems that have evaded, and will continue to evade, adequate regulation: First, banks have an incentive to engage in risktaking behavior due to explicit and implicit government support. Second, regulators cannot keep up with innovation in banking that is driven by the financial pressures on banks to be overleveraged.

Because it is unlikely that structural complexity in the banking system can be simplified enough to provide adequate monitoring, the most obvious way to avoid future problems is to change the risk structure at play in the banking system. One possible approach is through a measured challenge to the separation of banking and commerce—specifically, through commercial ownership of traditional banks.

Policymakers and academics have ignored the implications of the separation of banking and commerce for decades and have accepted this separation as an obvious guiding principle in banking regulation. This Article has attempted to clarify the debate surrounding the separation of banking and commerce by defining two forms of separation that have not previously been distinguished despite their important structural differences. This Article also makes a case for a wholesale reconsideration of the separation of banking and commerce in commerce.

The separation of banking and commerce in commerce has not had the effect it was intended to have and has in fact led to a more risk-prone banking system. The historical and recent advocates of separating banking and commerce in commerce have argued that allowing the two sectors to mix would create a risky structure that is prone to abuse and instability. Ironically, the BHCA, which was enacted to enforce the separation of banking and commerce, has caused a homogenous and conglomerated banking system that is increasingly vulnerable to collapse. Because banks can only be owned by or merged with other banks, they have become too large and too interconnected.

In light of these gradual changes and the systemic vulnerabilities the recent crisis has revealed, it is interesting to revisit the much-contested proposition of a Wal-Mart bank. In comparison to the conglomerated banking system that is supported by the Federal Reserve's indulgence, a Wal-Mart bank no longer seems like the calamity it was once thought to be.

APPENDIX: BANK HEALTH INDICATORS

The various bank regulators all use the Uniform Financial Institutions Rating System (also known as the CAMELS rating system) to determine the health of the banks they oversee. The six parts of the CAMELS rating system are: *C*apital adequacy, *A*sset quality, *M*anagement administration, *E*arnings, *L*iquidity, and *S*ensitivity to market risk.[300] The CAMELS rating system is comprised of a mix of objective and subjective standards, and the ratings themselves are confidential and kept from the public. However, a private party can estimate a bank's health through metrics that analyze the component parts of the CAMELS rating system. The most commonly used metrics include the capital-to-asset-ratio (to estimate capital adequacy), the troubled asset ratio (asset quality), and the return on assets ratio (earnings). These metrics facilitate a comparison between three cross-sections of the banking industry: all banks, Utah industrial banks,[301] and Utah ILCs with a commercial parent. On average, the data show that Utah ILCs with commercial parents are healthier than other banks.[302]

Capital-to-Asset Ratio. The capital-to-asset ratio is one measure of how well funded a bank is.[303] Generally, a high capital-to-asset ratio indicates that a large proportion of a bank's risk is being borne by its shareholders vis-à-vis the bank's creditors or the FDIC.[304] This ratio is an indication of a bank's ability to absorb losses without putting

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300 *See, e.g.*, *Risk Management Manual of Examination Policies*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/regulations/safety/manual/section1-1.html (last updated Feb. 8, 2005).

301 The Utah ILCs with assets as of September 30, 2010, are: ADB Bank, American Express Centurion Bank, BMW Bank of North America,* Capmark Bank, Celtic Bank Corporation, EnerBank USA,* First Electronic Bank,* GE Capital Financial Inc.,* LCA Bank Corporation, Medallion Bank, Merrick Bank Corporation, Optumhealth Bank, Inc., Sallie Mae Bank, Target Bank,* The Pitney Bowes Bank, Inc.,* Transportation Alliance Bank, Inc.,* UBS Bank USA, Webbank, Woodlands Commercial Bank, World Financial Capital Bank, and Wright Express Financial Services Corporation. *Financial Reports of Industrial Loan Companies*, *supra* note 229. The seven ILCs marked with an asterisk are owned by a commercial parent. *See UBPR*, FED. FIN. INSTS. EXAMINATION COUNCIL, http://www.ffiec.gov/ubpr.htm (last updated Nov. 16, 2011) (follow "UBPR Reports" hyperlink; select "Uniform Bank Performance Report (UBPR)" under "Report" heading; enter the applicable institution's name under "Institution Name" heading; then follow "Search" hyperlink).

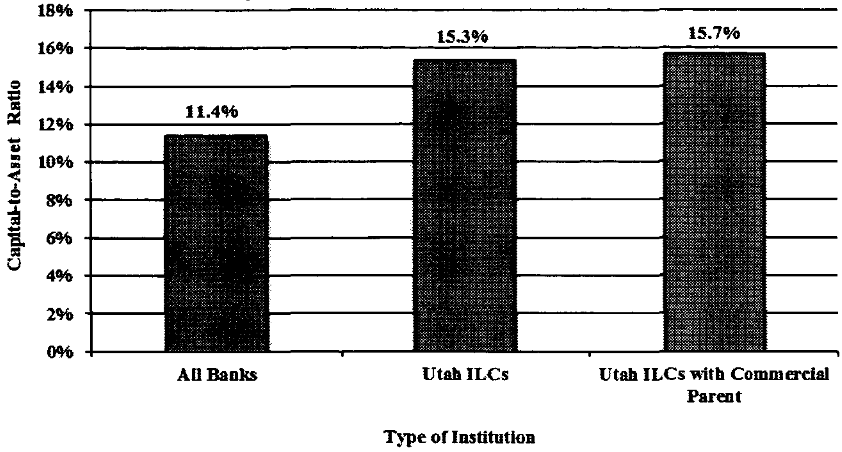
302 These results are substantially similar to the data derived from FDIC quarterly call reports as of June 30, 2010. NAT'L ASS'N OF INDUS. BANKERS, COMPARATIVE SAFETY AND SOUNDNESS OF INDUSTRIAL BANKS (2010), *available at* http://www.industrialbankers.org/wp-content/uploads/2010/02/NAIBDataQ2-10.pdf.

303 The capital-to-asset ratio is calculated by dividing the total assets by the total bank equity capital.

304 *See, e.g.*, Lee Gilliam, Note, *Accounting Consolidation Versus Capital Calculation: The Conflict over Asset-Backed Commercial Paper Programs*, 9 N.C. BANKING INST. 291, 293 (2005).

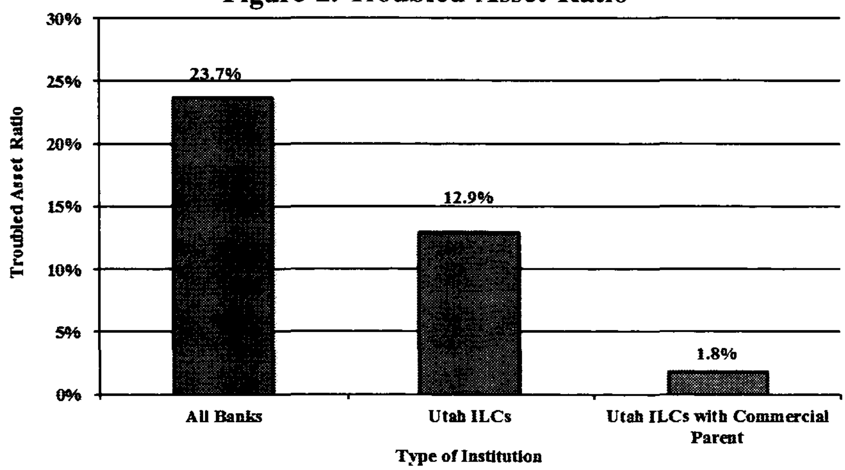
the bank at risk of failure. Generally, the higher the capital-to-asset ratio the more sound the bank is. Figure 1 shows that the average capital-to-asset ratio of both Utah ILCs and Utah ILCs with a commercial parent is higher than the banking industry as a whole.[305]

Figure 1. Capital-to-Asset Ratio



Troubled Asset Ratio. The troubled asset ratio compares noncurrent loans and other real estate owned (often repossessed) property as a proportion of the bank's total assets.[306] High levels of troubled assets indicate that stress is being put on the bank by its non- or underperforming loan portfolio. Figure 2 shows that troubled assets make

Figure 2. Troubled Asset Ratio



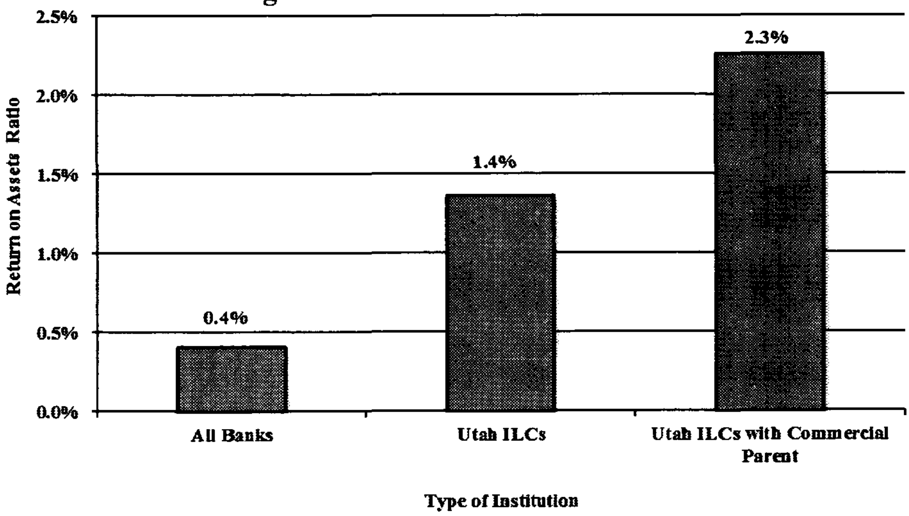
305 Figure 1 was produced by using data contained in *UBPR*, *supra* note 301.

306 The troubled asset ratio is calculated by dividing the sum of total capital and reserves (the sum of total bank equity capital and loan loss reserves) by the total troubled assets (the sum of nonaccrual loans and leases, noncurrent loans and leases, and other real estate owned).

up a much smaller percentage of the assets of commercially owned Utah ILCs compared to Utah ILCs as a whole, and an even smaller percentage than all banks.[307]

Return on Assets Ratio. The return on assets ratio is a measure of the profitability of a company.[308] A high ratio indicates that a bank is efficient, and effectively turns its assets into income. Figure 3 shows that commercially owned Utah ILCs are more efficient at turning assets into income than banks as a whole, and even other Utah ILCs.[309]

Figure 3. Return on Assets Ratio



307 Figure 2 was produced by using data contained in *UBPR*, *supra* note 301.

308 The return on assets ratio is calculated by dividing the average total assets for the last three quarters by the net income.

309 Figure 3 was produced by using data contained in *UBPR*, *supra* note 301.