

# Chicago Fed Letter

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## The Mixing of Banking and Commerce: A conference summary

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Acquisitions of industrial loan corporations by commercial firms have renewed the debate over the separation between banking and commerce in the U.S. On May 16–18, 2007, policymakers and academics weighed in on this debate during the Chicago Fed's 43rd annual Conference on Bank Structure and Competition, titled *The Mixing of Banking and Commerce*.

For more information on the Bank Structure Conference, see [www.chicagofed.org/BankStructureConference](http://www.chicagofed.org/BankStructureConference).

Recent efforts by Wal-Mart, Home Depot, and other commercial firms to acquire industrial loan corporations (ILCs), which are insured by the Federal Deposit Insurance Corporation (FDIC), have focused attention on ILCs in particular and the mixing of banking and commerce in general. Various interest groups, including community activists, labor unions, and business groups, and some members of Congress opposed those ILC applications. In response, in July 2006 the FDIC announced a six-month moratorium on all ILC applications. It extended the moratorium an additional year for nonfinancial firms in January 2007 and encouraged Congress to address the issue through legislation.

The separation of commerce and banking was codified in the United States with the passage of the Glass–Steagall Act of 1933 and the Bank Holding Company Act of 1956. The ILCs represent an exception to this prohibition: Federal legislation explicitly allows commercial firms to acquire and operate an ILC without being subject to the same supervision and oversight by the Federal Reserve as other bank holding companies. These firms can operate nearly identically to commercial banks, with deposit-taking and lending powers, as well as direct access to the federal safety net.

The recent proliferation of ILCs raises important public policy issues. It is often

argued that the U.S. has maintained the separation of banking and commerce out of concern that the mixing of such activities could have adverse effects, resulting from a rise in anticompetitive practices, a misallocation of credit, a reduction in credit availability in local communities, a loss in consumer privacy, or an overburdening of the federal banking regulators' supervisory resources. On the other hand, advocates of the banking and commerce mix argue that it would allow for greater risk diversification, help reduce information costs, and solve certain asymmetric information and control problems associated with commercial lending. This could present opportunities for synergies in cross-selling, provide consumers with "one-stop-shopping," and help U.S. banks remain internationally competitive, since such affiliations are common in other industrialized economies. This *Chicago Fed Letter* summarizes the discussion from this year's Bank Structure Conference on whether banking and commerce should mix and what the implications would be for policymakers, bankers, and consumers.<sup>1</sup>

### Should banking and commerce mix?

Charles Calomiris, Columbia University, started the discussion, citing various risks associated with mixing commerce and banking, including the risk that a bank might lend preferentially to its affiliate or parent or that it might not

lend to competitors of its commercial affiliate. A bank might also inappropriately marshal resources in support of a failing commercial parent or affiliate, which could jeopardize the bank's safety, potentially imposing costs on the deposit insurance fund. However, Calomiris argued that, while these may be legitimate concerns for countries where competition and prudential regulation are weak, they merit little concern in the U.S. "We have a highly competitive and very effective system, both in terms of bank competition and regulatory oversight," he explained, "and we already have very ample mechanisms from a regulatory standpoint, and from a private market competition standpoint, to deal with these potential risks."

suffer economically. More power will devolve to fewer and fewer hands, and economic diversity will wither, and with it, choices. While population centers may flourish, the decline of rural and small town America will accelerate. ... The less advantaged of our society will become even more disadvantaged." In Fine's opinion, banks play a unique role in financial systems, and they should not be combined and integrated into commercial and mercantile businesses. Relaxing the current restrictions would result in large, monopolistic conglomerates, with adverse effects for the consumer and society.

Cantwell Muckenfuss, Gibson, Dunn, and Crutcher LLP, questioned the potential for large conglomerate enterprises with

structure of regulation and supervision, with some existing ILCs being "grandfathered" and new ones being outlawed.

Mark Tenhundfeld, American Bankers Association, agreed with Fine's position that banks are special. A unique feature of banks is their pivotal role in credit markets and their obligation to serve as neutral arbiters of credit. His argument was fundamentally straightforward: Confidence in the banking system is of paramount importance. "If we don't have confidence in our banks," Tenhundfeld said, "we have a very big problem. And that, in a nutshell, is why we separate banking from commerce."

According to Tenhundfeld, there are two ways ILC affiliations, and the mixing of banking and commerce more generally, could undermine confidence in the banking system. First, the mixing could undermine the independence and neutrality of banks as rational, independent arbiters in the allocation of credit. The bank's credit decision could be based on factors other than the creditworthiness of the borrower. "When conflicts of interest are at play," stated Tenhundfeld, "the question of what's rational takes on a different complexion. The decision no longer is confined to whether it will benefit the bank. Indeed, it may become perfectly rational for a bank to act in a way that benefits the overall corporate entity, but is not in the bank's best interest." He argued that when a bank extends credit to an affiliate, customers of an affiliate, or suppliers of an affiliate, the credit judgment will be influenced by the affiliated relationship, and not the standard credit elements.

A second way that confidence in the banking system could be undermined would be by allowing a commercial entity to benefit from the bank's preferred status because of its access to the federal safety net. For example, a commercial entity could transfer low-quality or high-risk assets to the bank or sell them to the bank at inflated prices. Alternatively, the bank may provide guarantees to the parent's creditors, thereby conferring on the parent the benefits of the bank's status as an insured depository institution. "Conceivably," Tenhundfeld said, "the

## The 44th annual Bank Structure Conference will be held May 14–16, 2008, at the InterContinental Hotel in Chicago, IL.

Rather, Calomiris said the combination of banking and commerce would be beneficial as it would enhance technological innovation. "We have to take seriously the possibility that important innovations that might benefit consumers ... might come from outside the banking system, as they have in the past," he remarked. Further, he said that new entrants "have incentives to come in very aggressively because of the potential to skim the cream. That is, to get the profitable customers right away."

Calomiris contended that the mixing of commerce and banking would be very profitable because banking is a network business. "The microeconomics of this is the microeconomics of networks, not the microeconomics of scale per se, or of scope, in some technological sense," he argued. "That's what is going to be driving ... the mixing of commerce and banking. It's going to be on the consumer side. Very small entrants with good, big ideas on the technology side."

Camden Fine, Independent Community Bankers of America, took a very different perspective. If banking and commerce are allowed to mix, Fine argued, "Over time, the individual, the small business owner, small towns, and rural countryside will

substantial economic power to result from the mixing of banking and commerce. In his view, the concentration of market power argument is misplaced, given the structure and dynamics of the economy and antitrust laws. Muckenfuss argued that, instead of harming rural markets and underserved markets, the competition provided by the entry of major nonfinancial firms into banking and financial services would be beneficial for consumers, particularly those underserved by existing banking organizations.

Muckenfuss also dismissed other concerns related to the mixing of banking and commerce, such as the implications for the expansion of the federal safety net, potential problems with conflicts of interest, and unfair competition. Like Calomiris, Muckenfuss argued that these were not significant problems. The supervisory process; the existing rules governing affiliate transactions; the application process for new entrants; and the use of conditions to ensure the integrity, independence, and separateness of the bank within its corporate family, he asserted, amply address such concerns and insulate the bank. He was more concerned with the potential for piecemeal legislation by Congress that will leave a bifurcated

limited liability of banks could create risks for a bank in situations where the exposure of a nonbank affiliate exceeds the capital or net worth of the bank. In such a situation, the parent may conclude that it is in the consolidated entity's best interest to transfer the loss to the bank."

Finally, Thomas Huertas, Financial Services Authority in the UK, described what he thought made banks unique and how the U.S. regulation concerning acceptable banking activities, ownership, and affiliation with commercial firms differs from that in the UK and the European Union (EU). In the EU, commercial firms, including many firms headquartered in the U.S., own banks. Increasingly, Huertas argued, technology and market developments are blurring the distinction between banks and nonbanks.

For example, the EU defines a bank as an institution that grants credit for its own account, receives deposits from the public, and has a banking license. However, commercial enterprises extend credit for their own account via trade credit and delayed payment terms, private placements, and commercial paper. They can issue liabilities that are very similar to deposits, although not technically classified as deposits. They are also able to develop bank-like arrangements. For example, PayPal has over 100 million customers that are able to send and receive payments, hold balances, and even withdraw cash from ATMs. Thus, commercial firms can and do engage in banking-like activities.

Huertas addressed the following question to the conference: "If conflicts of interest can be managed, if connected lending can be regulated, and if commercial enterprises can be considered fit and proper owners of banks—as EU legislation and experience suggest—should the U.S. consider removing the barriers to allowing affiliation between banks and commercial firms?"

### **Evaluating the potential impact of mixing banking and commerce**

In addition to the theme panel discussion, empirical work on the potential impact of mixing banking and commerce on risk diversification, market structure, and bank service prices was also presented.<sup>2</sup>

Hsin-Yu Liang and Alan Reichert, both of Cleveland State University, and Larry Wall, Federal Reserve Bank of Atlanta, analyzed the potential diversification benefits of combining banking services with the provision of other financial and non-financial activities. Financial theory says that combining assets in an efficient portfolio allows an investor to obtain the same return at lower risk, or higher returns for the same risk, relative to that obtained with any individual asset. The researchers set out to see how substantial the potential gains are and which industries combined with banking provide the best risk–return trade-offs.

Using corporate income tax returns from the Internal Revenue Service for 1994–2002, Liang, Reichert, and Wall calculated the return on equity and return on assets for each of ten major industry categories, as well as the standard deviation and coefficient of variation of those returns as alternative industry risk measures. They then calculated the correlation of returns across the ten industry categories to evaluate the impact of combining banking with other sectors.

The results suggest that increasing returns could have been accomplished with minimum risk by combining banks with either one of the construction, retail, or wholesale sectors. Expanding the analysis to allow for broader diversification across all industry groups indicated that the potential for higher returns at the same level of risk was even greater. As risk and return increased, the efficient portfolio had banking combined with an increasing share of these same three industry sectors. Thus, they argued, the potential benefits from banking diversification appear to be quite significant.

As noted earlier, Wal-Mart's application to establish an ILC has raised significant concerns about its potential effect on banking competition. Since bank branches in retail stores have proliferated recently, and since Wal-Mart is the largest retailer in the U.S. with a substantial market presence in many markets, the potential effect of a Wal-Mart-owned depository institution on market structure and competition could be significant. To gain some insight into the potential effect of

a Wal-Mart-owned depository institution, Robert Adams, Robert Avery, and Ron Borzekowski, all of the Federal Reserve Board, analyzed the impact of branches of depository institutions that already operate inside Wal-Mart stores. While the analysis does not reveal how an actual Wal-Mart bank would function, it does reveal how important branch locations within Wal-Mart stores are to banks that operate them.

Using FDIC Summary of Deposits data and private information on branches located in Wal-Mart stores, the researchers found that in 1994 there were only seven bank branches located in Wal-Mart stores. By 2006, the number had grown to over 1,100 branches operated by some 300 distinct institutions. To see if the deposit-generating power of these bank offices differed from that of other new bank offices, the researchers examined changes in local market deposit shares following the introduction of bank offices in Wal-Mart facilities compared with the changes resulting when the same banks opened other branches (non-Wal-Mart offices) over the period 1994–2006.

The study separately analyzed the impact in rural markets and metropolitan statistical areas (MSAs). The results for first-time market entrants (versus banks

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expanding within a market) show that an institution opening a new branch in a rural market has, on average, about 6% market share within a year, which grows to approximately 9% in five years. Entering the market by introducing a branch in a Wal-Mart store results in a share “premium” of approximately 2% for each of the first five years of operation. The premium is not found in MSAs, where, in fact, the share gains from Wal-Mart branches are lower than in other markets. However, when market expansion occurs through the introduction of a Wal-Mart branch (instead of first-time entry), a similar premium is found across both urban and rural markets. The researchers argued that it is the complementarity of Wal-Mart branches with an existing distribution channel that makes the in-store locations valuable.

Finally, Li Hao, Debarshi Nandy, and Gordon Roberts, all of York University, presented the results from their cross-country study that assessed the extent to which a country’s bank regulation and supervisory practices affect the pricing of loans to borrowers in that country. Specifically, controlling for countries’ legal and institutional characteristics, the researchers looked at how the integration of banking and commerce and the concentration of the banking sector impact loan pricing. Integration could lead to better loan terms because of stronger lender–borrower

relationships and informational advantages that could lead to more efficient monitoring. The potential impact of market concentration is unclear. A more concentrated industry could result in higher loan prices if greater concentration is associated with the exploitation of market power—the “market power” hypothesis. Alternatively, market concentration may have resulted from the more-efficient firms growing to optimal size, and the resulting cost savings could be passed on in the form of lower loan prices—the “efficient structure” hypothesis.

Analyzing over 54,000 loan facilities in 49 countries for the 1989–2004 period, Hao, Nandy, and Roberts found that domestic lenders charge lower loan spreads as the degree of integration of banking and commerce increases. In those countries with a higher level of integration, however, foreign lenders charge higher spreads. They argued that this results from the foreign banks’ inferior lending relationships and a resulting need to exercise greater loan monitoring relative to the domestic lenders.

The benefit of lower loan costs received from domestic lenders due to banking and commerce integration vanishes in countries with high banking concentration. In these countries, foreign lenders charge lower loan spreads and provide more favorable contract terms. This aligns

with the “efficient structure” argument: The more-efficient foreign banks grow more rapidly, and they are able to pass on the efficiency gains in lower loan spreads.

## Conclusion

The future of ILCs and the potential for allowing the mixing of banking and commerce in the U.S. remain unclear. Congress plans to address the issue, but legislation has yet to be fully developed. The FDIC has extended the moratorium on nonfinancial ILCs, and some FDIC board members have suggested that unless Congress addresses the issue by the end of the moratorium, it would be difficult for regulators to justify denying future ILC applications. The development of sound public policy should be based on sound economic reasoning. The goal of the Federal Reserve Bank of Chicago’s 43rd annual Conference on Bank Structure and Competition was to help develop and debate that economic reasoning.

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<sup>1</sup> The conference addressed a number of additional issues, including Basel II capital regulation, payday lending activity, the changing real estate markets, risk management, financial stability, banking industry structure, and government-sponsored enterprises.

<sup>2</sup> Papers are available in Federal Reserve Bank of Chicago, 2007, *Proceedings of the 43rd Annual Conference on Bank Structure and Competition: The Mixing of Banking and Commerce*, forthcoming.