Reconsidering the Separation of Banking and Commerce

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This Article examines the long-held belief that banking and commerce need to be kept separate in order to ensure a stable banking system. Specifically, the Article criticizes the Bank Holding Company Act (BHCA), which prohibits non-banking 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 The inflexible and outdated provisions of the BHCA are a major cause of this movement toward conglomeration and homogenization. Since the enactment of the BHCA, the landscape of U.S. banking has changed dramatically. The strict separation of commerce and banking 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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I. INTRODUCTION

In 2005, during the heyday of banking, Wal-Mart Inc. petitioned the FDIC to open a bank. The controversy that followed was monumental—experts and the public were outraged and voiced their fears about a potential Wal-Mart National Bank. 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.

While 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 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. The risk of real loss diminishes incentives for risk-taking without a word of regulation.

In contrast, the current banking structure perversely incentivizes banks to increase leverage and risk exposure. When risk-taking causes banks to default or fail, the Federal government subsidizes losses explicitly through deposit insurance and implicitly through bailouts. 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 that promise significant returns on investments. What they have not done is to 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

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1 Mehrsa Baradaran, Associate Professor, Brigham Young University, J. Reuben Clark School of Law. I would like to thank the following people for their valuable comments on this Article: Geoffrey Miller, Erik Gerding, Christian Johnson, Julie Hill, Troy McKenzie, Gordon Smith, Darryle Rude, Christopher Robertson, Lisa Grow Sun, Ronnell Anderson Jones, Brigham Daniels, and Shima Baradaran. I would also like to thank workshop participants and commenters at the following law schools where this paper was presented: New York University School of Law, George Washington University, University of Utah, American University, Brigham Young University, and Golden Gate University. I would also like to thank my research assistants Brad Lowe, James Dunkelberger, and Evan Pack.


4 See id.

5 See infra Part III.C.2.

6 Collectively these are referred to as the “banking safety net.” See Andrew G. Haldane & Piergiorgio Alessandri, Banking on the State 3-7 (2009), http://www.bis.org/review/r091111e.pdf (describing the historical evolution of the banking safety net).
such as the Dodd-Frank reform, 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 hard to see the dangers lurking beneath the surface of enormous banking organizations. Indeed, some have argued that regulators had the power to prevent the most recent banking crisis, but that they did not do so because they did not recognize it for what it was. Unfortunately, given the complexity of the current system, it seems unlikely that Dodd-Frank will miraculously fix this regulatory blindness.

Thus, the cure 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. In this Article, I examine and challenge one of the guiding principles of banking regulation: the separation of banking and commerce, as enforced through the Bank Holding Company Act (BHCA). For decades, banking law has been guided by an unchallenged principle that commerce and banking should not be allowed to mix. The principle’s torch-bearers have claimed that its enforcement is necessary to ensure the safety of the banking system, when in fact it has led to a banking system more prone to collapse. In this Article, I will suggest 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 sub-concepts. In this Article, I will attempt to illuminate that confusion by distinguishing what I refer 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 II of this Article will define the separation of commerce and banking and describe and differentiate the various meanings inherent in the term; it will also briefly discuss the history associated with the different iterations of the principle. Part III will describe the precarious structure of modern banking that has been caused and exacerbated

8 Gretchen Morgenson, A Bank Crisis Whodunit, with Laughs and Tears, N.Y. TIMES, Jan. 30, 2011, at BU1 (discussing the recent report issued by the Financial Crisis Inquiry Commission and noting that the Fed, despite the financial crisis all around them, remained “defiantly inert and uninterested in reining in the mortgage mania” and continued their cozy relationships with large financial institutions).
9 See, e.g., Alan Greenspan, Testimony before the Financial Crisis Inquiry Commission, 10 (Apr. 7, 2010) available at http://c0182412.cdn1.cloudfiles.rackspacecloud.com/2010-0407-Greenspan.pdf (Mr. Greenspan testified: “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.”).
10 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 Bernard Shull, The Separation of Banking and Commerce in the United States: an Examination of Principal Issues, FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1 (1999).
by the enforcement of the separation of banking and commerce through the BHCA. Finally, Part IV will outline possible alternatives to the strict separation of banking and commerce, such as commercial ownership of traditional banks, and will analyze potential benefits and problems in such arrangements. Specifically, I will demonstrate the advantages of commercial ownership of banks by analyzing data from Industrial Banks, which are the only bank charter exempt from the BHCA restrictions on commercial ownership.

II. SEPARATION OF BANKING AND COMMERCE

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

12 PAULINE HELLER & MELANIE L. FEIN, FEDERAL BANK HOLDING COMPANY LAW 17-9, 17-10 (1997, 2010 ed.) (quoting 1947 Hearings at 22 (testimony of Federal Reserve Chairman Eccles)).
14 See Arthur Wilmarth, Jr., Wal-Mart and the Separation of Banking and Commerce, 39 Conn. L. Rev. 1539, 1565 (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 [S&L] debacle by enacting the Financial Institution 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 Wilmarth, Jr., The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis, 41 Conn. L. Rev. 963 (2009) [hereinafter Wilmarth, Dark Side of Universal Banking] (arguing that large financial conglomerates offering a variety of non-traditional, fee-based services helped precipitate the recent financial crisis).
15 HELLER & FEIN, supra note ___, at 17-9, 17-10 (quoting 1950 Hearings where Federal Reserve Chairman Thomas McCabe stated that “[O]f this fundamental truth I have become convinced: That the business of banking is a sacred public trust.”). See generally, Gerald Corrigan, Are Banks Special?, in FED. RES. BANK. OF MINNEAPOLIS, 1982 ANN. REP. 2 (1982), 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).
commercial activities would corrupt them.\textsuperscript{16} This assertion has not yet been convincingly studied.

\textit{A. Different Meanings of Separation of Commerce and Banking}

Although there are a number of possible ways that banking and commerce can mix,\textsuperscript{17} the most common are (1) banks engaging in non-banking activity and (2) commercial firms owning banks. I differentiate these two sub-concepts as “the separation of commerce and banking 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 commerce and banking” without making any distinction between the different iterations of this concept.\textsuperscript{18} However, the forms are quite distinct and incomparable. This oversight has led to a muddled discourse on the topic with abuses associated with the former being cited as justifications to prohibit the latter.\textsuperscript{19}

Even those scholars who have written about the separation of banking and commerce have neglected to clearly distinguish the two forms of separation.\textsuperscript{20} When Edward Symons wrote about the historic need for separating banking and commerce, he used historic 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.\textsuperscript{21} In addition, when Arthur Wilmarth argued that commercial firms should not be allowed to own banks, he relied on “several occasions” when “failures of depository institutions involved with commercial activities triggered serious financial crises.”\textsuperscript{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.

\textsuperscript{17} See Joseph Haubrich & Jaoa A.C. Santos, \textit{Alternative Forms of Mixing Banking with Commerce: Evidence from American History}, 12 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 121,122 (2003) (showing that there are at least 5 different examples of how commerce and banking 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.).
\textsuperscript{19} See infra Part II.A.2.
\textsuperscript{20} See, e.g., Stephen Halpert, \textit{The Separation of Banking and Commerce Reconsidered}, 13 J. CORP. L. 481 (1987-1988) (Halpert advocates for a mixing of banking and commerce, and although his history takes into account the BHCA, his examples and analysis do not deal with bank ownership, but rather activities conducted within a bank.).
\textsuperscript{22} Wilmeth, \textit{Wal-Mart}, supra note __, at 1554 (2007).
The mixing of banking and commerce in banking, which will be discussed below, has received much attention in the last several years and has been cited as one of the causes of the financial crisis. This separation was imposed by the Glass-Steagall Act in 1933, undone by the Gramm-Leach-Bliley Act in 1999, and re-applied by the Dodd-Frank Act through the Volcker rule. Most of the academic and regulatory debate for the last several decades has focused on this separation. However, regulating the separation of banking and commerce in banking 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, while this Article briefly details the inception of these two separations of commerce and banking, 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 banking crisis.

1. The separation of banking and commerce in banking

It seems settled from historic experimentation that when banks engage in commercial activities, there is instability and loss. In his seminal article, “The Business of Banking,” Edward Symons argued that since the early republic, banking regulators or their historic equivalents have attempted to stop banks from engaging in non-banking businesses because they saw banks losing their depositors’ money when they would engage in commercial activity. Policy makers wanted banks to be a safe place for deposits and posited that banks engaging in commerce compromised the public trust in the institution. Therefore, predating the New Deal and the regulatory fervor that opened the doors for the Glass-Steagall Act of

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23 See, e.g., Wilmarth, Dark Side of Universal Banking, supra note __.
24 After the stock market crash of 1929 and the banking crisis that ensued, contemporary observers believed, much like current commentators, that the mixing of commerce and banking contributed to the cause of the crash and the Great Depression. See Randall S. Krosner & Raghuram G. Rajan, Is the Glass-Steagall Act Justified? A Study of U.S. Experience with Universal Banking Before 1993, 84 AM. ECON. REV. 810, 810 (1994). In response, Congress passed the Glass-Steagall Act, which prohibited, inter alia, “commercial banks from underwriting, holding, or dealing in corporate securities, either directly or through security affiliates.” Id. This mandatory separation continued until the 1980s when the Federal Reserve Board permitted banks to own subsidiaries that engaged in securities dealing and underwriting. Feibelman, supra note __, at 960. Consequently, as a result of lobbying and the trend established by the Federal Reserve, Congress passed the Gramm-Leach-Bliley Act, which limited the Glass-Steagall Act and provided, inter alia, that entities that qualify 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 the Dodd-Frank Act which created a regulatory framework that effectively dismantled the Gramm-Leach-Bliley Act and reinstated many of the same principles of the Glass-Steagall Act. DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 4–6, (2011). Specifically, the Dodd-Frank Act, through the Volcker Rule, restricts banks’ proprietary security activities and sponsorship of private-equity firms. Id. at 85–87.
25 Symons, supra note __.
1933 (Glass Steagall), the National Bank Act and various other regulatory measures were designed to separate banking and commerce in banking.\textsuperscript{26}

The term “separation of banking and commerce” was first used to justify Glass Steagall, which initiated a prohibition on banks engaging in “non-banking” activities, such as securities or insurance underwriting.\textsuperscript{27} Before the stock market crash of 1929, banks had grown in size, moving away from the small, localized system of early American banking.\textsuperscript{28} Glass Steagall was a response to the general public sentiment that the Great Depression was caused by alliances between bankers and industrialists, which led to unfair and risky practices that brought down banks, commercial firms, and the U.S. economy.\textsuperscript{29} This analysis was not complete, but was accepted by the public as an explanation for the Great Depression.\textsuperscript{30}

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.\textsuperscript{31} 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.\textsuperscript{32} These restrictions remained in effect until 1999 when the Gramm-Leach-Bliley Act (Gramm Leach Bliley) repealed many of the important restrictions and firewalls imposed by Glass Steagall.\textsuperscript{33} 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.\textsuperscript{34}

\textsuperscript{26} See generally id. (discussing the phrase “the business of banking” and the ways in which it has been defined, since it was first used in the 1863 predecessor to the National Bank Act, to restrict bank powers).

\textsuperscript{27} Krainer, supra note __, at 16-17.

\textsuperscript{28} Carl Felsenfeld, The Bank Holding Company Act: Has It Lived Its Life?, 38 VILL. L. REV. 1, 6-10 (1993) (discussing the evolution of bank size from the time of the American Revolution through the early 1900s).

\textsuperscript{29} According to a summary by the Congressional Research Service of the Library of Congress: “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.” WILLIAM D. JACKSON, CONG. RESEARCH SERV., IB 87601, GLASS-STEAGALL ACT: COMMERCIAL VS. INVESTMENT BANKING 2 (1980); Felsenfeld, supra note __, at 44 (“Since [investing of the bank’s funds into business enterprises] was thought to be a cause of the financial collapse of the Great Depression, [Glass Steagall] was passed to stop the banks from engaging in commercial enterprise.”).

\textsuperscript{30} Several scholars have refuted the idea that the Great Depression was caused by relationships between bankers and industrialists. See FDIC, MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY (1987).

\textsuperscript{31} Blair, supra note __, at 100 (“In 1933, responding to the general belief that the nation's banking and economic problems had been caused by conflicts of interest between banks and their securities affiliates, Congress passed the Glass-Steagall Act, which prohibited affiliations between commercial and investment banking.”).

\textsuperscript{32} Wilmarth, Wal-Mart, supra note __, at 1564-65.

\textsuperscript{33} 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 __.

Recently the “Volcker rule,” which became part of the financial reform package passed by Congress in July 2010, reinstated these same restrictions.\(^{35}\) It was widely believed that proprietary trading within banks had led to banks engaging in riskier behavior, and that by prohibiting proprietary trading banks would focus on less risk-prone practices.\(^{36}\) 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.\(^{37}\) 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.\(^{38}\) Thus, the taxpayer need not provide a backstop to these risky activities.

The regulation of the activities banks may conduct will likely decrease some opportunities for risk-taking 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.\(^{39}\) 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 risk-taking 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 risk-taking 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.\(^{40}\) Notably, the BHCA was a reaction to a perceived threat that had not yet materialized.\(^{41}\) 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 banking subsidiaries. The BHCA was enacted to stop the feared expansion of Transamerica into a national banking conglomerate.\(^{42}\) The Federal Reserve Board feared Transamerica’s “commingling of banking

\(^{36}\) Josh Wolfson et al., The Dodd-Frank Wall Street Reform and Consumer Protection Act, 80 CPA J. 56, 56–60 (2010).
\(^{37}\) Cassidy, supra note __, at 25.
\(^{38}\) Id.
\(^{39}\) Id.
\(^{41}\) Blair, supra note __, at 100 (“[T]he general and long-standing distrust of large banking conglomerates combined with the increased merger activity of the 1940s and early 1950s led to the passage of the BHCA, which separated banking from commerce by restricting the activities of owners and affiliates of banks. The BHCA defined bank holding companies and established a framework for their regulation by the Federal Reserve. The restrictions on ownership and affiliation that are currently in effect stem from the BHCA and its subsequent amendments.”).
“and commerce” since it controlled the largest bank in the world, Bank of America, in addition to 46 other banks and numerous nonbank interests. After a failed attempt to combat the expansion through anti-trust laws, Congress passed the BHCA. 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. The BHCA was not created to react to a history of abuse, and no abuse was cited to justify its enactment. 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.” The Senate hearings further reveal that the BHCA was preventative rather than a response to existing problems, demonstrated by the fact that specific problems were not and could not be enumerated. The fears that the BHCA addressed could have 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. The BHCA’s primary purpose was to avoid the concentration of banking resources in one organization and to prevent the undue concentration of power that might result when banking and non-banking units were organized under one corporate firm.

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43 Felsenfeld, supra note __, at 64 (citing TransAmerica Corp. v. Bd. of Governors, 206 F.2d 163, 167 (3d Cir.), cert. denied, 346 U.S. 901 (1953)).
44 In 1948, the Fed 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: California, Oregon, Nevada, Washington, and Arizona. Section 7 of 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.” HELLER & FEIN, supra note __. The Fed 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. This failure to disband the perceived threat to American banking led to the Congressional enactment of the BHCA. Id. at 17-14, 17-15.
46 Daniel R. Fischel et al., The Regulation of Banks and Bank Holding Companies, 73 VA. L. REV. 301 (1987).
47 Thomas E. Wilson, Separation Between Banking and Commerce Under the Bank Holding Company Act, 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 comingling banking and commerce in a single corporate entity).
49 Halpert, supra note __, at 496-98 (Halpert explains that the position of the Board of Governors of the Federal Reserve, which favored restricting bank holding companies from engaging in nonbanking business, “contravened both history and logic.”) In the Senate hearings, the Board was unable “to identify any actual problem of “conflicts of interest.” Id. at 498. When a member of the Board was questioned “whether there was a danger that loans would be extended to bank affiliates improvidently,” he replied that he “[could not] think of a single violation.” When further pressed 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 498 n.16.
50 Felsenfeld, supra note __, at 5.
51 S. REP. No. 84-1095, at 2 (1955) (citing purposes of the BHCA: “(1) The 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) The combination
Even after the passage of the BHCA, the prohibition of commercial ownership of banks was not absolute. Any company could still own one bank. 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. As one-bank holding companies started to grow and expand, the BHCA was amended to cover them as well. 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 BHCA. This amendment initiated the complete separation of banking and commerce in commerce.

Despite the BHCA’s attempt at complete separation, there were many commercial firms that owned and controlled banks through exceptions and loopholes in the Act. For example, the BHCA defined a bank as an institution that both accepted deposits and made commercial loans. Many companies owned banks that engaged in one activity and not the other. 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 “non-bank” banks. After the passage of the 1970 amendment, “non-bank” banks became very popular and grew exponentially. In 1987, the Competitive Equality Banking Act (CEBA) was passed to address this expansion. CEBA broadened the BHCA’s definition of bank to cover many non-bank banks, making their owners subject to the activity restrictions of the BHCA. Commercial firms were forced to either divest themselves of their banking affiliates or become BHCs and stop their commercial activities.

Even CEBA, however, did not cover all commercial ownership of banks. CEBA grandfathered many banks already owned by commercial firms and made several substantial exceptions to its definition of a bank. CEBA allowed exceptions for other non-banks such as credit card banks, foreign banking institutions, savings associations, trust companies, credit

under single control of both banking and non-banking enterprises, permitting departure from the principle that banking institutions should not engage in business wholly unrelated to banking.”


[53] Id. at 1213.

[54] This would require, inter alia, that the firm “divest [itself] of non-banking affiliates and refrain from future acquisition of such enterprises.” Id. 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 __, at 1568 (2007) (citing 115 CONG. REC. 32,895 (1969) (remarks of Rep. Patman); id. at 32,903 (remarks of Rep. Moorhead); id. at 33,127 (remarks of Rep. Reuss); 116 CONG. REC. 32105–06 (1970) (remarks of Sen. Proxmire)).


[56] Haubrich & Santos, supra note __, at 32.

[57] Id.

[58] Id.


[60] Id.


[62] Blair, supra note __, at 101 (“[B]anking has never been absolutely separate from commerce.”).
unions, industrial banks, and banks in liquidation. Thus, a commercial firm could still own a 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 non-banks skyrocketed. Part IV will further address these entities, specifically the Industrial Bank, and analyze its structure and relationship with commercial firms as a successful example of a commercial-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 risk-taking. 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 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 of 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. In addition, advances in the financial and capital markets and the need for diverse funding sources led to alternative lending and investing alternatives that filled in the gaps left by traditional banks. Bank-like entities have emerged to provide many of the same services that used to be the sole jurisdiction of banks.

Banks used to be at the center of all lending and investing activities, and today they must compete with a variety of commercial lenders as well as the ever-accessible capital

63 Industrial Banks have also been referred to as Industrial Loan Companies (or ILCs), but in the state of Utah, the bank’s primary regulator has ceased calling these banks ILCs and refers to them as Industrial Banks. Mehrsa Baradaran, The ILC and the Recons truction of U.S. Banking, 63 SMU L. REV. 1143, 1145 n.12 (2010).
64 Competitive Equality Banking Act of 1987, supra note __.
68 In his seminal article, Are Banks Special, Gerald Corrigan argues that banks are special because they “offer transactional accounts,” provide the “backup source of liquidity for all other institutions,” and “are the transmission belt for monetary policy.” Corrigan, supra note __.
markets. Banks are no longer the only source of liquidity as they once were due to the capital markets, the commercial paper markets and various other non-bank sources of loans and liquidity. In addition, advances in technology and eliminations of geographical barriers, such as the Riegle-Neal amendment, have effectively opened banking to new competitors and larger markets. Thus, banks are no longer the repository and origin of all

69 Blair, supra note __, 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 __.

70 Jonathan R. Macey & Geoffrey P. Miller, America’s Banking System: The Origins and Future of The Current Crisis, 69 WASH. U. L. Q. 769 (1991). Additionally, Macey walks through the three ways that banks used to have the “edge” on the market. Id. at 772–73. Traditionally, banks were a unique financial intermediary with the ability of converting illiquid investments to liquid assets. Banks maintained central intelligence on information to assess credit and invest money, which being a costly process, gave them the edge of the market. In the 1970s and 80s, however, many large corporations switched from bank loans to securitized debt as an alternative to bank loans. Other lenders emerged over time, which removed the need for traditional bank liquidity. Because some of these competitors, such as mutual funds, produced higher yields to investors, customers started shifting funds from banks to these alternatives. 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 (2002) [hereinafter Wilmarth, Transformation].

71 Biagio Bossone, What Makes Banks Special? A Study of Banking, Finance, and Economic Development, 48 (World Bank Fin. Sector Strategy & Pol’y Dep’t, Working Paper No. 2408, 2000), available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2000/08/26/000094946_00081406502629/Rend ered/PDF/multi_page.pdf. The rise of capital markets and other sources of liquidity are a result of advances in technology that allow for the dissemination of information that banks had exclusive access to in performing intermediary functions. Macey & Miller, supra note __, 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.

72 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 Markets: Who’s Minding the Shop?, THE REGIONAL ECONOMIST, Apr. 1998, 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. Commercial paper use increased in the 80s and 90s and significantly reduced the amount of company spending that was previously financed through bank loans. Id. 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.

73 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. Because of these advances, performing transactions and distributing information is easier, cheaper, and more accessible to financial entities other than banks. The technological advances of the 1980s and 90s allowed financial markets to draw from a wider spectrum of borrowers. 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. Traditional banks faced competition as nonbank entities began providing fast and cost-effective banking services. Wilmarth, Transformation, supra note __, at 222.

74 The Riegle-Neal amendment effectively withdrew geographic restrictions on banks. Stacy Stritzel, The Riegle-Neal Act...Progress Toward a New Era in Banking, 46 SYRACUSE L. REV. 162, 163 (1995). Banks had previously used BHCs as vehicles for interstate banking; but with the branching restrictions removed, banks could move freely on their own. The expansion of banks across state lines was of course aided by technological advancements. Id.; See also Heather Landy, Financial ‘Supermarket’ Idea Re-Emerges, In Humbler Form, AM. BANKER, June 1, 2010, available at http://www.americanbanker.com/bulletins/-1020089-1.html (Online services started to take flight in the 1990s, allowing customers to access checking accounts or apply for mortgages or pay bills);
money, but merely one competitor in a larger market. 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 is considered core banking activities. 

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. However, the proverbial genie is out of 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 50 years ago due to fears of excessive 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.

III. The Bank Holding Company Act and the Banking Crisis

Given the seriousness of the turmoil sweeping over the banking system and how much worse it could have been, it is no accident that Congress stepped in with sweeping

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75 Finance companies, securities firms, and nondepository lenders have also expanded into the consumer loan market providing fierce competition for consumer lending, traditionally monopolized by banks. Wilmarth, Transformation, supra note __, 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. Macey & Miller, supra note __, at 773. The emergence of capital markets has competed with traditional banking by removing the need for the bank to analyze investments and gives 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." Edward Pekarek & Michaela Huth, Bank Merger Reform Takes An Extended Philadelphia National Bank Holiday, 13 FORDHAM J. CORP. & FIN.L. 595, 636 (2008).

76 See Blair, supra note __, at 108–09.

77 See, e.g., Markus Brunnermeier et al., The Fundamental Principles of Financial Regulation, Geneva Rep. on the World Econ. 11, at 1 (Jan. 6, 2009), http://fic.wharton.upenn.edu/fic/Policy_page/may1/Geneva_Report_11_conference_version.pdf (indicating that the current system is unable to deal with new financial instruments); Jackie Calmes & Louis Uchitelle, Obama to Propose Limits on Risks Taken by Banks, N.Y. TIMES, at A1 (Jan. 21, 2010) (quoting Paul Volcker as advocating more separation of commerce and banking to help remedy the financial situation).

78 The financial crisis crippled our economy to the point that “banks could not operate without government assistance, and businesses were unable to raise capital.” Secretary Timothy F. Geithner’s Written Testimony Before the Congressional Oversight Panel, Dec. 16, 2010, available at http://www.treasury.gov/press-
reforms on the heels of the banking crisis. Indeed, the Dodd-Frank bill passed by Congress in July 2010 represents the most expansive change in financial regulation since the 1930s.\textsuperscript{79} The bill is comprehensive and addresses some of the immediate causes of this crisis.\textsuperscript{80} However, it is uncertain whether Dodd-Frank is enough or too much. Dodd-Frank ambitiously sets out to reduce risk in the banking system and gird up our banks to resist bubbles and shocks, but it is quite difficult to test its strength. Because each crisis is unique, the real proof of the bill’s effectiveness will not be adequately demonstrated until the next crisis. Clearly, however, Dodd-Frank accomplishes many things. For example, the bill attempts to reduce systemic risk by regulating the activities that can be conducted within a bank,\textsuperscript{81} ensuring heightened disclosure,\textsuperscript{82} requiring more capital to offset risks\textsuperscript{83} and creating overseers to monitor systemically important financial firms.\textsuperscript{84} While 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.\textsuperscript{85} However, unless the strong incentive banks have to engage in risk-taking is somehow diminished, banking regulators will always be chasing (a few steps behind) innovation on Wall Street aimed at increasing profits.

While 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 easing the sacrosanct 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.
Baradaran, *Reconsidering the Separation of Banking and Commerce*

The BHCA was intended to deter conglomeration in banking and reduce systemic risk, but has had just the opposite effect.\(^8\) Thus, I will argue that loosening the BHCA, coupled with improved oversight, will result in a more diverse and secure banking structure. Easing some of the BHCA’s restrictions on commercial ownership of banks could solve a few of the current problems plaguing the banking system: that banks are too large and too homogenized to resist a contagion, and too structurally risk-prone. This section will examine these three major problems in banking that have been at least partly caused by the BHCA and illustrate 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, when banks merge, they can do so only with other banks. The last decade has seen a significant trend toward bank mergers. Bank mergers began to accelerate starting in the 1980s and through the 1990s.\(^8\) Since 1980, the number of FDIC-insured entities declined from 16,000\(^8\) to 7,635.\(^9\)

The collapse of the subprime market in 2007 resulted in a number of mergers among the biggest banks in the United States.\(^9\) Consolidation has led to domination of the market

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\(^8\)Pekarek & Huth, supra note __, at 604.

\(^9\)FDIC Financial Data, http://www2.fdic.gov/idasp/ (last visited Feb. 23, 2011). Mergers were possible despite the Bank Merger Act of 1966, which was originally enacted to support the BHCA’s movement toward anti-competition. Pekarek & Huth, supra note __, at 615. However, the 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 served.” Id. at 616 (quoting H.R. REP. No. 86-1416 (1960), reprinted in 1960 U.S.C.C.A.N. 1995 (S. 1062 later became the Bank Merger Act of 1960)). Additionally, federal authorities have relaxed the merger review standards after 1980 with the attitude that relaxed standards would encourage competition and allow larger, more efficient banks to absorb smaller banks. Wilmarth, *Transformation*, supra note __, at 250-51.

by a few. Currently, three banks—Bank of America, JPMorgan Chase, and Wells Fargo—control over 33% of Americans’ bank deposits. The mortgage industry is dominated by Wells Fargo and Bank of America, and five residential servicing firms now control over two-thirds of the nation’s housing debt. These large BHC conglomerates control a staggering market share and are so dominant in the banking sector that they have increasingly made it difficult for smaller banks or new entrants in the market to compete. 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. As the downturn levels off, even more acquisitions are anticipated. 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. Indeed, mergers are a natural result of an economic downturn. When a bank starts to falter, it can hedge its 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 (Wachovia’s share price had plunged nearly 74%). Citigroup and Wells Fargo spent the latter end of 2008 contesting 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.


Dash & Sorkin, Regulators Push for Sale of Wachovia, supra note __, at A15.

96 David Henry & Dakin Campbell, Get Ready for a Wave of Bank Mergers, BUSINESS WEEK, Sept. 16, 2010, http://www.businessweek.com/magazine/content/10_39/b4196051772374.htm?chan=magazine+channel_news+-markets+%2B+finance (“Conditions in the banking industry favor a new round of takeovers,” even though the four largest U.S. banks “may be too big to participate.”).

97 Robert Barba, Minnesota Deal May Illustrate Tiny Consolidation Trend, AM. BANKER, Sept. 29, 2009, at 5 (describing an acquisition in which a 22-branch, Minneapolis-St. Paul bank “would gain one branch in a suburb where it would like to be”).

98 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.”).
losses by combining with a stronger bank. After the recent crisis, smaller banks were hesitant to pursue mergers, but many larger banks were well poised to acquire smaller institutions. The largest banks in the country combined to create larger conglomerates, and regional and national banks followed the same trend.

Federal regulators have played a key role in encouraging bank mergers during the recent recession. Regulators use acquisitions “in times of distress to spread capital across the banking system to fill in the weak spots.” 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 funds for acquisitions in fear that more banks could fail unless they were merged.

Consolidation in banking was not limited to the largest banks. Small and mid-sized banks were left in a particularly weak and vulnerable position due to the recent crisis, and many were forced to merge or perish. This acceleration of mergers and small bank failures has led to diminished numbers of small and mid-sized banks. The loss of so many of these smaller banks affects the financing prospects of many small and mid-sized businesses, which

99 Jenny Anderson, Andrew Ross Sorkin, and Ben White, Shares Continue Decline as Lehman Looks for 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).
100 Kevin Dobbs, Buying, Selling, and the Question of Timing, AM. BANKER, Jan. 14, 2008, at 7 (discussing, among others, rumors that JPMorgan Chase would acquire Washington Mutual).
101 Matthew L. Cantor, Rethinking MeXA 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”).
102 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.”).
103 Investment Banking Editorial, Are 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 TBTF).
104 The Associated Press, 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’”).
105 The subprime crisis affected the housing industry and with housing projects drying up, small banks’ usual clients stopped borrowing. Graham Bowley, More Small Banks Ailing As Recession Toll Mounts, N.Y. TIMES, May 27, 2009, at B3. In addition, small banks weren’t assisted through the Troubled Asset Relief Program (TARP), since the objective was to keep big banks alive. This left small and mid-sized banks to fend for themselves and some either disappeared, downsized, or were swallowed up by bigger banks. Robert Barba, Extraordinary Measures: The Real ‘Scarlet Letter’ Was Not Receiving Tarp, AM. BANKER, Sept. 18, 2009, at 1. 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.
are the main customers of these banks. Currently, there is a shortage of financing options for these types of businesses as large banks conglomerate and chase after higher-yielding investments. 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.

1. TBTF 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. This implicit guarantee is troubling as it creates moral hazard and can lead to excessive risk-taking. The TBTF protection is also an incentive toward conglomeration because it rewards large, conglomerated banks with Federal Reserve protection—naturally, regulators may be more comfortable allowing smaller banks to fail.

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. Experts have noted that future bailouts are still likely to occur.

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108 Scott Medintz, *Getting the Loan Officer on Your Side*, 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).

109 The Federal Deposit Insurance Corporation Improvement Act in 1991 essentially codified a TBTF policy by saying that the FDIC would protect uninsured depositors in large failing banks if the action is to prevent “serious adverse effects on economic conditions or financial stability.” Wilmarth, *Transformation, supra note ___*, at 300. But describing a firm as “Too Big To Fail” is a bit of a misnomer because size is only one factor in determining if a bank’s failure will have “serious adverse effects on economic conditions or financial stability.”


112 Testifying before the Financial Crisis Inquiry Commission, Fed Chairman Ben Bernanke was asked if Dodd-Frank signaled that large institutions should be broken up. Donna Borak, *FCIC: Will Dodd-Frank Stop Future Bailouts?*, AM. BANKER, Sept. 3, 2010, at 1. He responded that size is not the issue, but management’s ability to monitor and mitigate risk. *Id.* 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.* While the particular method of bailing out a financial institution has been curbed, Bernanke seemingly did not want to take the stance that Sheila Bair did in saying, “There is no wiggle room for bailouts here. No more bailouts.” *Id.* Rather, Bernanke’s comments potentially foreshadow a future political pressure to rescue troubled institutions: “Few governments will accept devastating economic 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 other administrations might not refrain in the future. Thus, a promise not to intervene in and of itself will not solve the problem.” *Id.*
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. Experts note that bailouts will likely continue in private, with the Federal Reserve directing the movements. Perhaps bailouts will become even more likely under Dodd-Frank because there are now formal procedures in place.

2. Commercial firm ownership vs. large banking conglomerates

Commercial firm ownership can counteract the trend toward consolidation and offer small and medium-sized 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, and second, based on the experience of current commercially owned banks, these banks might better service the needs of the small and medium-sized banking market.

The fear of a 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. But the recent banking crisis demonstrated that the real threat to banking has come from within the sacred walls of banking and not 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 welcomed competitor.

113 Mark W. Olson, What Dodd-Frank Did and Did Not Accomplish, AM. BANKER, July 30, 2010, at 8. (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 government 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.) Potential wiggle room for a bailout may be found during troubled times by the Financial Stability Oversight Council, created by Dodd-Frank, as it can override or revoke rules established by the Consumer Financial Protection Bureau if those rules are found to threaten the soundness or stability of the financial sector. Gretchen Morgenson, Strong Enough for Tough Stains?, N.Y. TIMES, June 26, 2010, at BU1.


115 Olson, supra note __, at 8. In addition, Dodd-Frank shifts regulatory power from the FDIC to the Federal Reserve, who once it takes control of an institution, has the power 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. Peter Wallison, The Dodd-Frank Act: Creative Destruction, Destroyed, WALL ST. J., Aug. 31, 2010, available at http://online.wsj.com/article/SB10001424052748703369704575461714115902100.html.


If commercial firms could own banks, more small and mid-sized banks could survive and serve the needs of small and mid-sized 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 mid-sized business borrowers. A recent New York Times article lauded the firm as being one of the only remaining lenders that services the small and medium-sized business loan sector with great success. They can do so because they are not forced to compete with the large banks for their clientele. Due to the backing of their commercial parent, they are able to leave the herd of large banks competing for the same customers.

These small and mid-sized 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. Parent firms with stable cash flows would be able to support a subsidiary bank’s liquidity problems. 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 troubled 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. 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 waiting for each other to fall, or a house of cards that was easily toppled when one or two players collapsed. As 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 causes a contagion effect among the commercial banking sector. For example, leading up to the recent crisis, many large banks that were previously

118 Lipton, supra note __, at A1.
119 Id.
120 Baradaran, supra note __, at 1185.
121 Lipton, supra note __, at A1.
122 News Hour (PBS television broadcast Mar. 21, 2008) (Jim Lehrer used falling dominos to describe the fallout of the financial system).
not interested in investing in subprime mortgage products could no longer stay away from these high-yielding securities because they needed to keep up with their competitors and because their businesses were built around contracts and exchanges with their counterparts.\textsuperscript{125} 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.\textsuperscript{126} This behavior causes bank holdings to become highly correlated, which means that they are more likely to stand or fall together.\textsuperscript{127} Herding is evidenced through lending strategies: lending to similar industries, specializing in certain products, or lending to similar sets of customers.\textsuperscript{128} 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 of the correlated firms would also be affected.\textsuperscript{129} This creates a “Too Many To Fail” problem. Such herding behavior was evidenced during the recent financial crisis in the form of overinvestment in subprime and other mortgage-related assets.\textsuperscript{130}

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 systemic risk, but collectively they may.\textsuperscript{131}

Thus, the assets held by major banks and bank holding companies are positively correlated with each other, which means that they move up or down at the same time.\textsuperscript{132} 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.\textsuperscript{133} If one imagines the banking sector as a giant portfolio of investments, the portfolio is subject to increased systemic risk due to its highly correlated assets. This risk could be reduced by diversifying assets among sectors so that 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 contagion, which is “the spillover of the effects of shocks from one or more firms to others.”\textsuperscript{134} Contagion in banking

\textsuperscript{125} Wilmarth, \textit{Dark Side of Universal Banking}, supra note __, at 1008.

\textsuperscript{126} 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. Banks consciously invest in correlated assets to ensure the optimal environment. \textit{See} Viral V. Acharya & Tanju Yorulmazer, \textit{Information Contagion and Bank Herding}, 40 J. OF MONEY, CREDIT & BANKING, 215, 224–25 (2008).

\textsuperscript{127} Id. at 224.

\textsuperscript{128} Id. at 228.

\textsuperscript{129} Id. See also Andrew Kahr, \textit{Column: Blame ‘Systemic Risk’ on Groupthink}, Oct 12, 2010, AM. BANKER, at 9.

\textsuperscript{130} Thomson, supra note __, at 140.

\textsuperscript{131} \textit{See also} William N. Goetzmann, \textit{An Introduction to Investment Theory}, YALE SCH. OF MGMT., http://viking.som.yale.edu/will/finman540/classnotes/class2.html.


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is theorized to be more potent than contagion in other sectors, with potential to spread further and more quickly. 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 because their assets are usually tangible products or services, 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 up a partner or subsidiary bank during a banking crisis.

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. Thus, when one bank is believed to be on the brink of failure, it triggers concern about the solvency of other banks. Otherwise-uncorrelated risk exposures of a few, similarly situated banks can become highly correlated during times of financial distress. This is less likely to occur among commercial firms, where information is more readily available and the differences between firms are more readily apparent. Additionally, commercial firms are generally better capitalized than banks and can withstand bigger adverse shocks, reducing the contagion spread as compared with banks.

Evidence of contagion among banks continues today. During the recent crisis, many banks failed because they did not have enough assets that were unaffected by the 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 the lender’s best response to refuse to roll over its loans even if the firm would be solvent if all loans were rolled over. Such liquidity crises are similar to bank runs.”).

“In comparison to other industries, absent federal deposit insurance, bank 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) and, 5. Spread more beyond the banking industry and cause substantial damage to the financial system as a whole and the macro-economy.” Kaufman, supra note __, at 126.

Id. at 128.

See Baradaran, supra note __, at 1185-86.


Id. at 129.

Thomson, supra note __, at 140.

See Kaufman, supra note __, at 129 (noting that return contagion is less likely to occur when depositors are able to differentiate and perceive differences in financial institutions and that investors in the stock market “successfully differentiated among banks on almost all occasions”).

Id. at 130.

“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,
housing crisis to counterbalance their losses.\textsuperscript{144} 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.\textsuperscript{145} 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.\textsuperscript{146}

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,\textsuperscript{147} while others suggest that contagion risk is clearly evident in banking.\textsuperscript{148} 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.\textsuperscript{149}

2. Commercial firms as a source of strength

The FDIC looks to parent companies to be a “source of strength” for their banks, which means, as defined by the Federal Reserve, that “holding companies should use their available resources to provide adequate capital funds to their subsidiary banks during periods of financial stress or adversity.”\textsuperscript{150} However, when ownership is limited to bank holding

\textsuperscript{144} Erik F. Gerding, \textit{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).


\textsuperscript{146} \textit{Id.} Wells Fargo and Citigroup ended up competing for the chance to buy Wachovia, with Wells Fargo ultimately winning the bidding war. See Dash & Sorkin, \textit{Regulators Push for Sale of Wachovia, supra note \_\_}, at A15.

\textsuperscript{147} George Kaufman argues: “Are banks ‘special’ or ‘unique’ relative to other firms with 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, \textit{supra note \_\_}, 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.” \textit{Id.} at 144.

\textsuperscript{148} 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, \textit{Contagion Risk in Banking}, in Bank of Japan, 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/cbr/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.” \textit{Id.} at 101.

\textsuperscript{149} Thomson, \textit{supra note \_\_}, at 139.

companies, the parent companies will often be struggling during times of financial distress as much as the subsidiary bank because their assets are tied up in the same financial markets. Most BHCs are mere shell companies that own various banking subsidiaries with no assets of their own.\footnote{For example, Citigroup has over 200 subsidiaries on which it, the BHC parent, depends on for revenue. CITIGROUP INC., FORM 10-K (2010) exhibit 21.01, available at http://www.sec.gov/Archives/edgar/data/831001/000120677411000316/exhibit21-01.htm (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 30 to 40 percent stake in it. \textit{Id.}}

A better source of strength would be a commercial firm whose revenues are not correlated with the weaknesses of a subsidiary bank. While the financial sector has been hit hard, many commercial firms have remained stable because “credit arrangements are generally medium- or long-term and not collateralized by assets that can lose their value quickly.”\footnote{\textit{Id.}} 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), 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 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.\footnote{\textit{Id.} at 409 (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).} However, failures of non-financial firms happen with less swiftness and intensity.\footnote{James Bullard et al., \textit{Systemic Risk and the Financial Crisis: A Primer}, 91 FED. RES. BANK OF ST. LOUIS REV., 403, 408–09 (2009).} Financial firms operate with highly-leveraged capital structures as opposed to commercial firms’ more modest risk exposures.\footnote{\textit{Id.} at 408 (identifying anomalies and failures in the financial markets that led to meltdown and examining various hypotheses for why they occurred).} 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

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\footnote{For an explanation of what CDOs are, see \textit{infra} note \_ and accompanying text. For an in-depth discussion of the involvement of CDOs in the subprime mortgage meltdown, see generally Steven L. Schwarz, \textit{Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown}, 93 MINN. L. REV. 373 (2008) (identifying anomalies and failures in the financial markets that led to meltdown and examining various hypotheses for why they occurred).}

\footnote{For example, Citigroup has over 200 subsidiaries on which it, the BHC parent, depends on for revenue. CITIGROUP INC., FORM 10-K (2010) exhibit 21.01, available at http://www.sec.gov/Archives/edgar/data/831001/000120677411000316/exhibit21-01.htm (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 30 to 40 percent stake in it. \textit{Id.}}
years and even decades, because unlike financial firms, their assets do not disappear overnight.

Banks have illiquid assets (loans) and highly liquid liabilities (deposits), making them susceptible to runs. This illiquidity and vulnerability increase systemic risk.\(^{157}\) In contrast, commercial firms typically have medium- to long-term liabilities (loans) and relatively liquid assets (inventory) that do not lose their value quickly. While banks struggle to use long-term assets like loans to offset short-term liabilities like demand deposits, commercial paper, and repurchase agreements,\(^{158}\) many commercial firms have inflowing cash from the sale of their goods or services. In contrast, banks susceptible to funding shortages and “runs” may be forced to sell assets in a fire sale to meet short-term liquidity requirements.\(^{159}\)

An illustrative example of this relationship is the interaction between the few bank-owning commercial firms struggling in bankruptcy and the viability of their subsidiary banks.\(^{160}\) 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.\(^{161}\) From the experience of industrial banks, even weakened commercial firms can serve as a source of strength to their banks.

A commercial parent of a bank could serve as a stop gap for losses when its subsidiary bank falters. It could perform the same protective function as the Federal Reserve and the FDIC serve for failing banks. This more stable and less correlated business model could stop a financial contagion from overpowering the subsidiary bank. Thus, a commercial parent can serve as a source of strength to a struggling bank in a more effective way than a BHC.

**C. Current Banking Model Creates Incentives for Risk-taking**

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.\(^{162}\) Moreover, consolidation naturally increases risks because it leads to less

\(^{157}\) See id.

\(^{158}\) Bullard et al., supra note __, at 410.


\(^{160}\) See Baradaran, supra note __, at 1181–82.

\(^{161}\) See id. “The following is the FDIC summary of the Conseco failure: ‘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.’ See also Blair, supra note __, at 114. For the GAO’s discussion of Conseco, see GAO REPORT, supra note __, at 58.” See also Patrick Fitzgerald, *Lehman Seeks to Inject Cash to Save Banks from Regulators*, DOW JONES FIN. INFORMATIONAL SERVS., Feb. 12, 2009.

\(^{162}\) See supra Part III.A.
diversity of products and players. 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. The banking industry suffers from a well-known moral hazard problem caused primarily by state support of banks. 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. 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. One way to do this is to invest depositor money in funds that bear more risk and have a higher yield. As rational actors, banks weigh the benefits of greater risk against the potential losses. However, banks do not suffer the full consequences of loss because the losses consist of depositors’ money that is protected by the FDIC fund.

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 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. Banks with “no skin in the game” are not properly incentivized to avoid risks. A “no skin in the game” problem exists when the players who make the decision of how much risk to assume are not affected by the loss. Banks are in this situation as 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. As a result, banks also have a weakened incentive to protect the goodwill and

163 Wilmarth, Transformation, supra note __, at 445.
164 Lucian Bebchuck & 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.”); Okamoto, Moral Hazard, supra note __, 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.”).
165 Bebchuck & Spamann, supra note __, at 255, fn 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 __, at 3.
166 Okamoto, Moral Hazard, supra note __, at 192-93.
167 See id. at 185.
168 See id.
169 Id. at 204-05.
170 My forthcoming essay regarding the tragedy of the commons in banking will further address this problem.
171 See, e.g., Schwarz, supra note __, 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 take on excessive risk).
172 See Karl S. Okamoto, Skin in the Game, LEGAL TIMES, Sept. 28, 2008, at 52 [hereinafter Okamoto, Skin in the Game].
173 Id.
174 See Bebchuck & Spamann, supra note __, at 252. Haldane & Alessandri point out: “[i]n the early days of
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 collateralized debt obligation (CDO) pool.\(^{175}\) WaMu created risky loans and sold them right away and was rewarded based on the volume of loans, regardless of the level of risk associated with the loan.\(^{176}\) 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.”\(^{177}\)

Moreover, FDIC deposit insurance creates an additional unavoidable moral hazard problem for banks because it 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.\(^{178}\) 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.\(^{179}\) 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 banks 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.\(^{180}\) This disadvantage is amplified as banks get bigger and, some argue, become too big to regulate.\(^{181}\) 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.

\(^{175}\) Okamoto, \textit{Moral Hazard}, \textit{supra} note \underline{209}, at 209. “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.”

\(^{176}\) Id.

\(^{177}\) Id.


\(^{179}\) See generally Haldane & Alessandri, \textit{supra} note \underline{33}, arguing that banks have an incentive to take risks and be overleveraged because of state support of banking.

\(^{180}\) Bebchuck & Spamann, \textit{supra} note \underline{34}, at 281.

\(^{181}\) 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. 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. 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. When these high-risk assets fell into default, the banks suffered tremendous losses. Thus, while regulators were trying to force banks to reduce risk exposure, they led them 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.

As discussed, banks also have an incentive to conceal risks, making it even more difficult for regulators to detect risks. Further, banks have a larger 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. 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 agencies are often insufficiently funded. 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.

2. Commercial firms and “skin in the game”

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182 Haldane & Alessandri, supra note __, at 10.
183 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.”).
184 Haldane & Alessandri, supra note __, at 10.
185 Id.
186 See, e.g., Okamoto, Moral Hazard, supra note __, at 211 (“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.”); see also Stephen Breyer, Regulation and Its Reform 184 (1982) (providing a more in-depth discussion of the “pitfalls of overzealous regulation”).
187 See supra text accompanying notes 170–73.
188 See id. at 205.
190 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 what is a proprietary trade and one made on behalf of clients. See Lucchetti & Strasburg, supra note __.
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 their risks. In the past, when a commercial firm has attempted to own a bank through one of the limited exceptions in the BHCA, such as an Industrial Bank, the FDIC has typically entered into a capital guarantee contract with the firm whereby the firm assures that it will pay the liabilities of the bank in the event of a failure before FDIC payout.\footnote{If the BHCA were loosened, as this Article is proposing, and commercial firms were allowed into banking, this type of contract would have to be a precursor to any ownership arrangement. Without such an agreement, commercial owners would not be much better than BHCs without any 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.} If the BHCA were loosened, as this Article is proposing, and commercial firms were allowed into banking, this type of contract would have to be a precursor to any ownership arrangement. Without such an agreement, commercial owners would not be much better than BHCs without any 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.\footnote{Requiring 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. The increased prices of such bonds cause the stakeholders to internalize the costs, materially reducing moral hazard. See Greenspan, supra note __, at 11.}

Forcing ownership of risk assures that a commercial parent has “skin in the game,” thus creating a natural incentive for reduced risk-taking. Without the assurance of government bailouts, firms would bear a greater share of the losses if they were to fail, reducing moral hazard. As Warren Buffett aptly advised, firms must be forced to “eat [their] own cooking.”\footnote{He recently explained one of his investments by saying: “In short, we eat our own cooking…no other testimonial means more.” Letter from Warren Buffett to Berkshire Hathaway Shareholders (2009), available at http://www.berkshirehathaway.com/letters/2009ltr.pdf; cf. Mark Tier et al., 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).}

IV. 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.\footnote{See Emre Ergungor & James B. Thompson, INDUSTRIAL LOAN COMPANIES, Econ. Comment, (Federal Bank of Cleveland, Cleveland Ohio), Oct. 1, 2006, available at http://www.clevelandfed.org/research/Commentary/2006/1001.pdf; ILCS – A Review of Charter, Ownership, and Supervision Issues: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Fin.} Recently, private equity firms have begun to
enter the banking fray through an FDIC program that encourages such firms to purchase failing banks.\textsuperscript{195} Private equity ownership of banks will be the focus of an upcoming article.

There are two ways a traditional commercial firm can own an FDIC-insured depository institution.\textsuperscript{196} The first is to own a single thrift as a unitary thrift holding company.\textsuperscript{197} Unitary thrift holding companies can engage in any commercial enterprise as long as the thrift meets certain activity restrictions.\textsuperscript{198} The second way a commercial firm can own an FDIC-insured bank is to own an Industrial Bank, discussed below.\textsuperscript{199}

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 has entered and dominated a financial market previously controlled by banks. PayPal is not a bank and not regulated by banking regulators, but for its over 220 million customers, it provides bank-like services.\textsuperscript{200} 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 worldwide markets with yearly revenue of $2.8 billion.\textsuperscript{201}

Technological innovation has led many commercial firms to more holistically service 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.

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{196} 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. The One Bank Holding Company “loophole” was closed, however, by amendments to the Bank Holding Company Act in 1970. The other two options remain. \textit{See Larry D. Wall et al., The Final Frontier: The Integration of Banking and Commerce, Part I: The Likely Outcome of Eliminating the Barrier, \textsc{Fed. Res. Bank of Atlanta Econ. Rev.}, No. 1, 2008, at 1, 9-11, http://www.frbatlanta.org/filelegacydocs/er08no1_wall.pdf.}
  \item \textsuperscript{197} \textit{Id.} at 11. Commercial firms that own thrus through unitary thrift holding companies include E*Trade, H&J Bank, ING Direct, John Deere, Macy’s, Nordstrom, Raymond James, Scottrade, State Farm, T. Rowe Price, Allstate, and Edward Jones. \textit{See Office of Thrift Supervision, Holding Company Search, http://www.ots.treas.gov/?p=HoldingCompanySearch (under “Bank Type” search “Stock HC Owning Only Thrift(s)”).}
  \item \textsuperscript{199} The most important restriction is the Qualified Thrift Lender Test, which basically requires that around 65% of the lending of the thrift be to home- or mortgage-related lending. \textit{See Office of Thrift Supervision, Historical Framework for Regulation of Activities of Unitary Savings and Loan Holding Companies, http://files.ots.treas.gov/48035.html (last visited Feb. 16, 2011).} Other restrictions are meant to ensure 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. \textit{See id.}
  \item \textsuperscript{201} PayPal is owned by eBay and contributes 37% of eBay’s annual revenue. \textit{Id.}
\end{itemize}
\end{footnotesize}
These firms have found that in order to stay profitable and fully service their customers, they need to offer financial services without a middle-man. UPS, for example, offers its clients a variety of services, including shipping and packaging of merchandise, as well as financing services. In 1998, UPS started UPS Capital to provide asset-based lending and factoring to some of its commercial clients. Today it offers a wide range of supply chain financing options, small business lending, insurance, and other financial services.

Other institutions are offering services that initially belonged to banks. 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. 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 remittance, and money orders. Retailers, such as 7-11, Nordstrom, and even universities, such as Drexel University, offer various banking services. Similarly, IBM Global Financing, Hewlett Packard Financial Services, and Dell Financial Services each offer financing for businesses looking to upgrade their technology. Caterpillar Financial offers direct financing and insurance products for its equipment purchasers.

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” operate 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 safely for thirty years outside the scope of the BHCA. The Industrial Bank came under intense scrutiny due to Wal-Mart’s infamous

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203 Helen Stock, UPS Hopes Loans Deliver Customers; Finance Unit Makes Asset-based Loans to New and Small Businesses, AM. BANKER, Nov. 17, 2000, at 1; see Baradaran, supra note __, at 1193.
205 Pekarek & Huth, supra note __, at 633-35.
207 Id.
208 Pekarek & Huth, supra note __, at 633-35.
application and was the subject of a House and Senate bill aimed at its termination. While 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. Even Dodd-Frank addresses Industrial Banks by imposing a moratorium on new Industrial Bank charters and commissioning a GAO report on the safety of the charter. 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 with traditional BHCs.

Companies with Industrial Banks include GE, BMW, Toyota, Pitney Bowes, Harley Davidson, and Target. Industrial Banks have been eligible for FDIC insurance since 1982 with some provisions that distinguish them from traditional retail banks. Many of the major auto manufacturers use Industrial Banks to offer financing options to purchasers and dealers of their automobiles. Commercial giant GE offers a wide variety of financial services through GE Capital and GE Money, including commercial lending and leasing, consumer financing, and real estate financing. GE Money Bank also issues many private label retail credit cards, including for stores like J.C. Penney and Wal-Mart. 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 from 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. They are primarily found in the state of Utah and have been operating successfully for several decades. To date, no commercially owned Industrial Bank failure has caused

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215 Pursuant to CEBA, an Industrial Bank is not a “bank” for purposes of the BHC Act 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 $100,000,000, or (3) that any company has not acquired control of the institution after August 10, 1987.” 12 U.S.C. § 1813(a)(2) (2006); see also Christian Johnson & George G. Kaufman, A Bank by Any Other Name, ECON. PERSP., 4Q 2007, at 37, 41.
216 Johnson & Kaufman, supra note __, at 42-43.
219 For a thorough analysis of Industrial Banks, see Baradaran, supra note __.
220 Id. at 1145.
any amount of loss to the FDIC insurance fund.\textsuperscript{221} According to various industry measures, Utah Industrial Banks are among the healthiest banks in the country. 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.\textsuperscript{222} Commercially owned Industrial Banks have a healthier risk profile than their non-commercially owned counterparts according to bank health measures commonly used by the FDIC.\textsuperscript{223} Although several of the Utah Industrial Banks lost money in 2008 and 2009, they remain well-capitalized overall and have good asset quality.\textsuperscript{224}

Utah regulators and Industrial Bank supporters attribute this success to the vigilant regulatory structure that surrounds the firms as 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.\textsuperscript{225} 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.\textsuperscript{226} 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 start-up costs and pitfalls.\textsuperscript{227} Most traditional banks only achieve this level of security and efficacy after many years in operation.

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, it has gained strength over time, and it 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.

\textsuperscript{221} 

\textsuperscript{222} 
I compared 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.

\textsuperscript{223} 
See infra Appendix.

\textsuperscript{224} 
See infra Appendix.

\textsuperscript{225} 
Sutton Interview, supra note \textsuperscript{229}.

\textsuperscript{226} 
Rude Interview, supra note \textsuperscript{229}.

\textsuperscript{227} 
Sutton Testimony, supra note \textsuperscript{229}. 

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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.\textsuperscript{228} However, as 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.\textsuperscript{229} Those that argue that the separation of banking and commerce is part of the American tradition do not accurately depict the realities of early banks or historic ties between banking and commerce.\textsuperscript{230} Many of the early bank charters were controlled by industrialists who used their banks to support their commercial activities.\textsuperscript{231}

Second is the argument that banking regulators lack the authority to exercise adequate supervision over commercial parents of subsidiary banks.\textsuperscript{232} Some argue that without Federal Consolidated Supervision\textsuperscript{233} of bank parent companies, the financial system is less stable\textsuperscript{234} and the parent company is more prone to risk.\textsuperscript{235} Federal Consolidated Supervision is meant to catch weaknesses in a BHC before it poses a threat.\textsuperscript{236} In contrast to Federal Consolidated Supervision, the argument is that the FDIC is limited in the scope of its supervision and the extent to which it can examine a commercial parent of a bank.\textsuperscript{237} The

\textsuperscript{229} See supra note 12 and accompanying text.
\textsuperscript{231} The Bank of the Manhattan Company was formed by the Manhattan Company, which was formed to provide New York City with safe water. The bank became the largest in the city as well as the state, and survives today as Chase Manhattan Bank. See FDIC, Mandate for Change, supra note __, at 121-22. Additionally, “in the nineteenth century, for example, Moses Taylor owned controlling interests in the National City Bank (a forerunner of Citibank), as well as 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 __, at 155. For additional examples of investors that have had controlling interests in both banks and commercial firms simultaneously, see Huertas, supra note __, at 744.
\textsuperscript{232} See Wilmarth, \textit{Wal-Mart}, supra note __, at 1613–16; Kohn Testimony, supra note __, at 11–14.
\textsuperscript{233} 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’NS OF SUPERVISORS OF BANKS OF THE AMERICAS, CONSOLIDATED SUPERVISION 15 (2008), available at http://www.asbaweb.org/Grupos/libros/fscommand/doc7.pdf.
\textsuperscript{235} Wilmarth, \textit{Wal-Mart}, supra note __, at 1617.
\textsuperscript{236} See Kohn Testimony, supra note __, at 11.
\textsuperscript{237} The FDIC can examine an affiliate only to the extent “necessary to disclose fully (i) the relationship between [the Industrial Bank] and any such affiliate; and (ii) the effect of such relationship on the [Industrial Bank].” Wilmarth, \textit{Wal-Mart}, supra note __, at 1613.
regulator cannot impose capital requirements on parent companies and has limited authority to bring administrative proceedings against parent companies and affiliates. 238 It is also argued that the FDIC does not have the expertise to identify or control risk in a commercial firm. 239

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 sniffing out and addressing the failures in the financial system. 240 The problems with regulation discussed above affect the regulators equally. Dodd-Frank was a recognition that many of the regulatory agencies were doing duplicative work, which resulted in inefficiencies, and collectively, they missed the danger signs that they were tasked to address. 241

Many of the commercial firms that would own banks are regulated by the SEC and their subsidiary banks are regulated by the FDIC. 242 These two regulators have the opportunity to detect risk in these companies and communicate the risk to each other. In addition, in the case of Industrial Banks, the FDIC has broad powers to issue cease and desist orders to parent companies who it views as endangering their subsidiary bank. 243 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 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. 244

The final argument against mixing banking and commerce is that doing so would expose banks to risks inherent in commerce while extending the federal safety net to the commercial sector. 245 As an extension of the “too big to fail” argument, it is presumed that

238 Id. at 1614.
239 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 1619.
240 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 ________.
244 Baradaran, supra note ___, at 1162 n.163 (providing an example where the FDIC issued a cease and desist order against Fremont Investment and Loan, Brea California, and its parents).
245 See Wilmarth, Wal-Mart, supra note ____, at 1589–93, 1607–13. 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., ALESSANDRI & HALDANE, supra note ___, at 8 (arguing that banks have an incentive to take risks and be overleveraged because of the banking of the state). It is also argued that commercially-owned banks and Industrial Banks are subject to additional risks when owned by a commercial company because the risk of a
the government would step in to save a failing commercial parent if either it or its subsidiary bank was considered too big to fail.\textsuperscript{246} This assurance would effectively subsidize large commercial firms\textsuperscript{247} and extend the safety net to entities that are unsupervised by banking authorities.\textsuperscript{248} This unfair advantage, it is said, would encourage conglomeration and concentrate economic power,\textsuperscript{249} and increase the risk of monopolies,\textsuperscript{250} predatory pricing,\textsuperscript{251} and other anticompetitive activities.\textsuperscript{252}

The systemic risk argument is the most important of these arguments because it encompasses the others and because the safety and soundness of the banking sector is the first priority in banking regulation.\textsuperscript{253} Most regulation aims at ensuring safety and soundness in banking and attempts to make rules and create structures to promote that. Would commercial ownership of banks promote greater safety and soundness in banking? Because banking and commerce have been separated for many years while the banking system has undergone a dramatic change, there is no empirical data suggesting that commercial parents would endanger banks or the banking system on the whole. The best indicators of the potential success of commercial-banking alliances are existing structures. The Industrial Bank is one such structure, and as this Article has demonstrated, these entities are a


\textsuperscript{247} Wilmarth, \textit{Wal-Mart, supra note }\textsuperscript{246}, at 1590-91.


\textsuperscript{249} Cantwell F. Muckenfuss & Robert C. Eager, Presentation at the Federal Reserve Bank of Chicago 43rd Annual Conference on Bank Structure and Competition, The Mixing of Banking & Commerce: The Separation of Banking and Commerce Revisited 48, 52 (May, 2007) (citing GAO REPORT at 72-73); \textit{see also} Kohn Testimony, \textit{supra note }\textsuperscript{246}, at 128 (“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.”).

\textsuperscript{250} Jones Statement, \textit{supra note }\textsuperscript{246}.


successful example of the mixing of banking and commerce in commerce. These banks have remained robust and sound despite widespread banking collapse, and they have done so not in spite of but because of their well-funded commercial parents.\footnote{Baradaran, \textit{supra} note __, at 1195. In addition, a recent study analyzed commercial and banking interactions at the entity level, or in other words—not with respect to banks engaging in commercial activity, but with respect to banks interacting with commercial firms. The study found that there are benefits when banks are involved with their corporate debtors in the commercial lending context. 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. Adam Feibelman, \textit{Commercial Lending and the Separation of Banking and Commerce}, 75 U. CIN. L. REV. 943, 974 (2007).}

In the absence of data that justifies the separation of banking and commerce in commerce, both the success of Industrial Banks, as well as 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 risk-taking by forcing some parent companies to internalize their risks.

1. \textit{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? These are valid questions and the answers lie in well-thought-out structures and vigilant regulation. As discussed, there are several risks and pitfalls in commercial ownership of banks and regulators would have to appropriately monitor these potential hazards.

Regulation would have to address the size of the bank vis-à-vis the commercial parent to ensure that the commercial parent was larger and better funded than a bank, and that a bank was being used to service the commercial firm as opposed to the other way around. In other words, a small commercial firm should not be the parent of a large bank because should the bank run into problems, the commercial parent could not be a source of strength. 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.\footnote{Baradaran, \textit{supra} note __, at 1189} 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.\footnote{Id.} 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 their banks as a means to support their business and not vice versa.\footnote{See \textit{supra} Part IV.A.}

It is also possible that a commercial firm could be a source of weakness. In that scenario, 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, which would not be
difficult. There are several barriers already included in the BHCA—such as Reg 23A and 23B—that are designed to prevent transactions between affiliates.\textsuperscript{258} Regulators would need to be vigilant in addressing such breaches and detecting others. However, there is no indication that these rules would more easily be breached with a commercial parent than with the existing structure of banks and their affiliates.

What about the criticisms of bank regulation discussed above? Is it possible to say that regulators cannot do some things and are adequately capable of doing others? I believe the answer is yes. It is difficult for regulators to enforce rules that go against a bank’s natural incentives, like enforcing lower risk exposure when high risk exposure can pay handsomely. However, regulators can adequately monitor businesses to ward against fraud and self-dealing or enforce bright line rules.\textsuperscript{259} Thus, it would not be difficult for regulators to prevent a commercial firm from siphoning bank funds or increasing the size of its bank to the point that it overwhelms the commercial firm.

2. Can regulators monitor non-banking businesses?

Another concern is whether banking regulators can adequately monitor risks associated with a commercial firm. This argument asserts that while 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.\textsuperscript{260} However, this argument assumes 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.\textsuperscript{261} A banking regulator can regulate a subsidiary bank and assure that the bank’s operations are not in violation of imposed limits while a commercial regulator can oversee a parent firm.

Regulators of Industrial Banks operate in this manner and have been successful at regulating the banks and communicating with a regulator of a parent company, usually the SEC, when the need has arisen.\textsuperscript{262} It is also a misconception that the same people who


\textsuperscript{259} See Raghuram Rajan, Cycle-Proof Regulation, ECONOMIST, Apr. 11, 2009, at 79 (arguing that “regulators rarely have the political or intellectual independence to exercise discretion” and 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-for-_545281.html.

\textsuperscript{260} Wilmarth, Wal-Mart, supra note __, at 1613-14.

\textsuperscript{261} 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, Banking Regulation: The Dual State-Federal Regulation of Financial Institutions—A Policy Proposal, 53 BROOK. L. REV. 53, 55 (1987) (identifying the various federal agencies that regulate banks).

\textsuperscript{262} Section 10(b) of the FDI Act 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,
manage the company manage its bank.\footnote{http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html (last updated Jun. 25, 2004).} In the Industrial Bank sector, the banks are often run by experienced bank managers with little control exerted on day-to-day operations by commercial management.

3. Excessive power?

One of the initial stated reasons for the separation of commerce and banking was the fear of excessive power. Given Wal-Mart’s controversial practices in the past,\footnote{Utah, for example, requires that managers of Industrial Banks have extensive bank management experience, and that a majority of the Industrial Banks board of directors be made up of independent members. See State of Utah, \textit{What is an Industrial Bank?}, http://www.dfi.utah.gov/whatisIB.htm (last visited Feb. 23, 2011).} it is reasonable to be wary of a Wal-Mart national bank and fearful that it could drive many smaller banks out of business. However, as discussed above, most national banking chains are much larger than Wal-Mart and continue to grow, and most small banks have fallen prey to their expansion.\footnote{Tom Bliley, \textit{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.”)} Many large companies have owned banks for generations without any damage to competing small banks.\footnote{\textit{Supra} Part II.A.}

The BHCA was passed due to fears of excess power, and those who continue to advocate for the separation of banking and commerce in commerce continue to display these fears. However, modern trends in banking do not support this apprehension. On 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, serious systemic damage.

V. CONCLUSION

The U.S. banking structure has two inherent problems that have and will continue to evade adequate regulation: First, banks have an incentive to engage in risk-taking behavior due to explicit and implicit government support, and second, regulators cannot keep up with innovation in banking driven by the financial pressures on banks to be over-leveraged.

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. In this article, I have 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. Then, I have made 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 historic 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.
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: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. Although the CAMELS rating system is composed of a mix of objective and subjective standards—and the ratings themselves are confidential and kept from the public—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 (Earnings). Using these metrics allows a comparison between three cross-sections of the banking industry: all banks, Utah Industrial Banks (ILCs), and Utah ILCs with a commercial parent. On average, the data show that Utah ILCs with commercial parents are healthier than other banks.

1. Capital to Asset Ratio

The Capital to Asset Ratio is one measure of how well funded a bank is. Generally, a higher capital ratio indicates that a greater proportion of a bank’s risk is being borne by its shareholders vis-à-vis the bank’s creditors or the FDIC. This figure is an indication of a bank’s ability to absorb losses without putting the bank at risk of failure. Generally, the higher the Capital to Asset Ratio the more sound the bank is. The chart in Figure 1 shows that the average Capital to Asset Ratio of both Utah ILCs and Utah ILCs with a commercial parent are higher than the banking industry as a whole.

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269 These results are substantially similar to a report compiled as of June 30, 2010 by EnerBank USA titled “Comparative Safety and Soundness, The Industrial Banking Industry, Second Quarter 2010.”
270 The Capital to Asset Ratio is calculated by dividing Total Bank Equity Capital into Total Assets.
2. Troubled Asset Ratio

The Troubled Asset Ratio\(^{272}\) compares non-current loans and “other real estate owned” (often repossessed property) as a proportion of the bank’s total assets. Higher levels of troubled assets are an indication of the stress being put on the bank by its non- or under-performing loan portfolio. Figure 2 shows that troubled assets make up a much smaller percentage of the assets of commercially owned Utah ILCs compared with Utah ILCs as a whole, and an even smaller percentage when compared with all banks.

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\(^{272}\) The Troubled Asset Ratio is calculated by dividing the Total Troubled Assets (Non-Accrual Loans and Leases, plus Non-Current Loans and Leases plus Other Real Estate Owned) into the Total Capital plus Reserves (Total Bank Equity Capital plus Loan Loss Reserves).
Return on Assets is a measure of the profitability of a company. A higher ratio is an indication of a bank’s efficiency and how effectively it is turning its assets into income. Figure 3 shows that commercially owned Utah ILCs are more efficient than banks as a whole, and even other Utah ILCs, at turning assets into income.

![Return on Assets Chart]

Source: FFIEC Uniform Bank Performance Reports, as of Sept. 30, 2010

Figure 3

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273 The Return on Assets Ratio is calculated by dividing Net Income into the Average Total Assets for the last three quarters.