From: KENMIA22
Sent: Saturday, August 19, 2006 6:51 PM
To: Comments
Subject: Comment on Industrial Loan Companies and Industrial Banks from Ken Thomas

Please consider the attached American Banker commentary as my comment on ILCs and IBs.
Thank you,

Kenneth H. Thomas, Ph.D.

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Viewpoint: Wal-Mart, CUs, and a Level Playing Field
From: American Banker
Friday, July 14, 2006
By Kenneth H. Thomas

The American banking industry always seems to be at war with another financial industry believed to have an "unfair" competitive advantage.

The most recent turf wars have been with credit unions and over the proposed Wal-Mart Bank.

S&Ls Then, Credit Unions Now. The last time the banking industry complained about an unlevel playing field with a major financial industry involved another type of federally insured depository thrift, savings and loans.

Under the Fed's Reg Q, beginning in 1966, S&Ls had a distinct rate advantage over banks (initially 0.5%, but later 0.25%). But unlike credit unions, S&Ls paid taxes and had to comply with laws similar to those governing banks.

Bankers protested the rate differential, a powerful marketing tool in an era of deposit rate controls. The influential S&L lobby, however, convinced Congress that an attack on them was an attack on the American Dream of homeownership.

That industry's focus on home lending, the reason for their favored regulatory treatment, was also the beginning of their end when their mismatched balance sheets encountered inflation-induced double-digit interest rates, the gradual elimination of rate controls, and the birth of less-regulated competitors, like money market mutual funds.

Without reliving the morbid details of the S&L crisis and bailout, the impact on the industry was simple -- strong thrifts became banks, and weak thrifts became history. The surviving thrifts, including mutuals that pay taxes, now march with bankers in their protests against their common credit union enemy.

Credit unions have an unfair competitive advantage in the retail market, because they are exempt from both direct income taxes and an indirect regulatory "tax" in the form of compliance with the Community Reinvestment Act.

The resultant lower cost of operations allows them to pay higher deposit rates and charge lower fees and loan rates. Like S&Ls, credit unions, with their powerful lobby and friends in Congress, have maintained a government-granted competitive advantage that makes them a lower-cost provider.

The Data Disclosure Disadvantage. Another competitive advantage credit unions enjoy over other federally insured depositories has not previously been discussed as a matter of public policy.

This is their exemption from the disclosure of midyear branch deposit data, something banks and thrifts have been doing for over 25 years.

This was an insignificant issue when credit unions were employer-based and had no retail branches. Today, however, this disclosure exemption translates into a valuable advantage.

Credit unions know exactly how much every bank branch and thrift office has on deposit every June 30 from the FDIC's Summary of Deposits. Credit unions can use this market information to make better decisions on branch location and other matters. Banks have no way to track credit union deposit activity, other than watching customer traffic and tracking transferred accounts.

A recent branching study I conducted on a local market confirmed just how significant credit unions are today in retail banking.

The FDIC reports roughly $1.5 billion on deposit in about 45 bank offices in this market. Community-based credit unions, with their rapid growth and branch expansion, now have 15 offices there, many of them dwarfing nearby bank branches. After looking at total credit union deposit levels and local branch customer activity, I estimated that the 15 offices have about $500 million of deposits.

Thus, the FDIC data understates the size of this retail banking market by 25%, in terms of both offices and deposits. This is a significant amount, even if these deposits were given less weight because of credit unions' perceived smaller competitive impact.

This is a matter of public policy, since these figures are used in antitrust calculations in local markets for merger and other regulatory decisions. Understating of the competitive impact of credit unions may lead to suboptimal regulatory decisions.

The Politics of Credit Unions. S&Ls justified their favored status through their promotion of housing finance when no other industry was so specialized. However, there is no compelling public policy argument for these credit union exemptions.

With the increased concern over the budget deficit, I cannot understand how Congress can justify the tax exemption for this $700 billion industry, which reported nearly $6 billion of net income last year. The Tax Foundation estimates that the exemption costs the government about $2 billion annually.

As a staunch CRA advocate, I see no reason why credit unions nationwide are not subject to the law; those in Massachusetts have been subject to CRA-like ones since 1982. Their reports, along with my experience in consulting for both banks and credit unions, show that some do a much better job than others in serving their entire community.

Not surprisingly, credit unions use the same argument community banks unsuccessfully used to try to exempt themselves from the CRA: "We wouldn't be in business if we didn't serve the community."

Even the strongest credit union supporters should concede that their exemption from branch data disclosure is unwarranted today.

It is only a matter of time before credit unions lose this triumvirate of exemptions. Exactly when that happens will depend on the relative strength of the credit union lobby versus the banking one. So far the former has been winning the battle.

Sears Then, Wal-Mart Now. Before Wal-Mart became a household word, Sears was our nation's top retailer for most of the last century, not just with its sprawling nationwide store network, but also with its mail order catalog and telephone support, the snail-mail predecessor of online retailing.

With its excellent growth, franchise, and reputation, Sears decided to branch into financial services.

It had long been a player but became a major force in 1931 with the establishment of Allstate Insurance and, later, Allstate Savings and Loan in California, which became Sears Savings Bank. Sears later acquired the industry leaders Coldwell Banker Real Estate and Dean Witter Financial Services.

With the success of its financial affiliates, the retailer established the Sears Financial Network in 1982. These one-stop financial centers, planned for more than 800 stores nationwide, would offer full-service insurance, realty, investment, and thrift services.

In an Aug. 2, 1982, article "Selling Socks and Stocks," Time magazine reported on this "experimental" financial supermarket where customers could buy stocks, bonds, insurance, and houses, and even open IRAs. The launch of Sears Mortgage Corp. and the Discover card (with no annual fee, a high credit limit, and a "Cashback Bonus") further strengthened its position as a major financial provider.

As it has done with the proposed Wal-Mart Bank, the banking industry protested Sears' getting into the retail banking business. The industry's rallying cry became "We have nothing to fear but Sears itself!"

Despite these protests, Sears pursued its in-store financial operations, but they never met with great success. Sears finally closed them and later spun off its major financial subsidiaries.

Other retailers, like J.C. Penney and K-Mart, even toyed with the idea of in-store financial centers, but they suffered the same fate. Meanwhile, these major retailers suffered, since they took their eye off their core business, which was being targeted by aggressive competitors like Wal-Mart and category killers like Toys-R-Us.

Like today's supermarket chains, whose in-store branches have met with only sporadic success, these retailers learned that retail banking habits were difficult to change, mainly because of the continued preference for traditional delivery systems, with their high-touch and evolving high-tech capabilities.

The same general arguments against Sears' getting into the banking business are now being used against Wal-Mart. Stripped of all its rhetoric, the banking industry is again trying to protect its turf from a new, aggressive competitor with deep marketing pockets.

Let the Market Regulate. Wal-Mart is a low-cost provider as a result of disciplined and experienced management, not unlike Southwest Airlines and other new competitors that have shaken up traditionally regulated industries.

Credit unions, however, are low-cost providers as a result of direct and indirect tax exemptions. While success of the former companies can be justified, and even commended, the opposite is true for the latter.

I am not suggesting that Wal-Mart will follow in Sears' footsteps, or that credit unions will suffer the same fate as S&Ls. That is for the market to decide.

Banking regulators and Congress are charged with representing the public interest, rather than that of the banking or credit union industries. History has shown and will continue to show that competition is in the public interest. Competition, however, is not enough if it is played on an unlevel playing field, as presently is the case with credit unions.

Good public policy would suggest not only a more positive view of Wal-Mart's planned entry into banking, but also the gradual elimination of the branch data disclosure, CRA, and tax exemptions for credit unions, in that order.

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