Testimony of
Lawrence J. White[*]
at the Hearing on
"ILCs – A Review of Charter, Ownership, and Supervision Issues"
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives
July 12, 2006

I am pleased and honored to have this opportunity to testify before this Subcommittee on today's important topic. In the pages that follow, I will lay out a principled policy approach[1] that the U.S. regulatory system for banks and other depository institutions[2] should follow in considering matters such as the whether non-financial companies should be allowed to own depository institutions, including industrial loan corporations (ILCs).

This approach uses the concept of "examinable and supervisable" to delimit the activities that should be allowable for a bank. All other activities that are otherwise legal should be permitted for the owner of a bank (including a bank holding company), so long as the activities occur outside of the bank and the direct and indirect financial relationships and transactions between the bank and its owner are closely scrutinized.

The logical implication of this approach is that any party that is otherwise qualified (e.g., is financially capable, has a sound business plan, and is of sound character) should be allowed to own a bank, so long as the bank itself is adequately capitalized and competently managed and the activities

[*] Stern School of Business, New York University, 44 West 4th Street, New York, NY 10012-1126; tel: 212-998-0880; e-mail: Lwhite@stern.nyu.edu. This statement represents solely my own views and is not made on behalf of any organization. During 1986-1989 I was a board member of the Federal Home Loan Bank Board.

[1] Greater detail and support for the positions advanced in this statement can be found in the books and articles that are cited at the end of this statement.

[2] In this statement, unless I indicate otherwise, the term "banks" broadly covers all depository institutions.

of the bank (and its relationships and transactions with its owner) adhere to the delimitations just described.

Accordingly, I believe that the ownership of ILCs by non-financial companies represents a sensible direction for public policy. Indeed, I believe that banking charters generally, whether state or national, should be expanded so that non-financial companies can readily own banks, subject to the limitations that I have described. If it is the Congress's judgment that the Federal Deposit Insurance Corporation (FDIC) and other bank regulators do not have the authority or capabilities to conduct the monitoring of the financial relationships between the parent/owner and the bank that is necessary, then the Congress should pass legislation that would give the regulators this authority and/or the resources to develop the capabilities – rather than preventing these potentially productive ownership arrangements.

As a related matter and following the same logic, I believe that banks or bank holding companies should be allowed to enter the business of real estate brokerage.

The rest of this statement will expand on these ideas.

I. The Rationale for Safety-and-Soundness Regulation of Banks.

Banks are special. That concept lies at the center of why banks are subject to a special kind of government regulation: safety-and-soundness regulation.

Banks' specialness generally arises from their generic combination of assets and liabilities: relatively illiquid assets (usually loans) and highly liquid liabilities (deposits). This combination makes banks potentially vulnerable to rapid withdrawals of depositors' funds: "runs". In addition, banks are at the center of the economy's payments system, so they have constant creditor-borrower relationships among themselves, leaving banks exposed to potential losses (and preemptive runs) at each other's hands.

Liability holders generally worry about a corporation's losses because of the legal principle

of limited liability: Once a company's losses have exhausted its owners' equity (or net worth), the owners are generally no longer liable for any further losses, which will have to be absorbed by the liability holders. Though this a general problem that extends to the creditors of all corporations (who then try to protect themselves through covenants and lending restrictions), it is a special problem for banks, for at least three reasons:

First, some bank depositors may be relatively unsophisticated, poorly informed, and in a poor position to protect themselves against the losses from a bank's insolvency; also, banks tend to be more opaque (and thus more difficult to be informed about) than are other enterprises.

Second, and related to the first, banks are especially vulnerable to runs by imperfectly informed depositors -- or even by informed depositors who fear runs by imperfectly informed depositors.

Third, and building on the first two, there may be a "contagion" effect, whereby imperfectly informed depositors of one bank, seeing a run on another bank, may fear for the solvency of their own bank (or may just fear that other depositors of their own bank will become fearful and begin to withdraw). Alternatively, since banks are frequently in the position of being a short-term lender or borrower vis-a-vis other banks, the insolvency of one bank may set off a cascade of insolvencies of other creditor banks (or may cause a contagion of runs by banks-as-creditors who have imperfect information and fear insolvency).

II. The Response: Safety-and-Soundness Regulation.

Some version of these scenarios (plus, historically, the perceived position of banks as special lenders) has caused the American polity -- since the early nineteenth century -- to treat banks as special and to develop special regulatory regimes to deal with their specialness. At the center of such regimes have been efforts to maintain banks' solvency, so that the value of their assets remains greater than the value of their liabilities -- to keep them "safe and sound". Since 1933 federal deposit

insurance has provided an additional layer of assurance (and thus an additional damper on potential runs) by protecting depositors against regulatory failure.[3]

At the heart of safety-and-soundness regulation are four key components: (a) minimum capital (approximately, net worth) requirements, to keep banks solvent;[4] (b) limitations on activities, to prevent excessive risk-taking;[5] (c) management competency requirements, to prevent inadvertent insolvencies; and (d) in-the-field examiners and supervisors, to enforce the rules.

III. What Activities Are Appropriate for a Bank?

As the previous section indicated, limitations on banks' activities are one of the key components of safety-and-soundness regulation, as part of the effort to limit banks' risk-taking (since the "downside" from risk-taking will usually be bank losses).

But what limitations on banks' activities make sense? The logic of safety-and-soundness regulation has an immediate implication: The only activities that are appropriate for a bank are those that are "examinable and supervisable": those for which regulators are capable of assessing risks and of setting commensurate capital requirements and also for which the regulators can make judgments about the competence of the bank's management of the activity. This examinable-and-supervisable decision ought to be a regulatory judgment, but the political appointees heading the regulatory agency should be held accountable for those judgments.

---

[3] In an important sense, with deposit insurance in place, safety-and-soundness regulation becomes the rules that protect the deposit insurer (as well as uninsured depositors and other creditors).

[4] Capital plays two important roles: First, it is a direct indicator of a bank's solvency -- the buffer of protection for depositors against a fall in the value of the bank's assets. Second, since capital is essentially the owners' equity, it provides a disincentive for the bank's owners to take risks.

[5] Activities mean broadly all kinds of assets, liabilities, or ongoing business operations of a bank.

IV. What Activities Are Appropriate for a Bank's Owners?

Any activity that is not appropriate for a bank (because regulators are unable to set capital requirements and/or to judge managerial competence with respect to the activity) should nevertheless be permitted for the bank's owners, regardless of whether the owners are individuals, a corporation, or a bank holding company.[6] However, it is crucial that all transactions between the bank and its owners (or subsidiaries of the owners, or friends and associates of the owners) must be closely monitored by regulators, because it is relatively easy for funds to be siphoned out of a bank (and thus leave the bank insolvent): The bank can pay excessive dividends to its owners; or it can undercharge for the services that it provides to its owners (e.g., it can extend loans to owners at concessional interest rates or that simply do not get repaid); or it can overpay for goods or services bought from its owners.[7]

In essence, any direct or indirect transactions between the banks and its owners and affiliates must be on arm's-length terms and monitored closely by regulators, and penalties for violations must be severe. This is the logic that sensibly underlies Sections 23A and 23B of the Federal Reserve Act.

A stylized way of portraying the appropriate locations for activities and the need for monitoring is provided in Figure 1.

V. Some Examples.

[6] The location of the (non-examinable-or-supervisable) activity -- whether it is lodged directly with the owners (or the bank holding company) or in a separate subsidiary of the owners or a subsidiary of the bank (so long as that subsidiary is separately capitalized -- i.e., the subsidiary's net worth does not count as an asset for the bank) -- is much less important than its exclusion from the bank itself.

[7] The risks of siphoning funds out of the bank through undercharging or overpaying also apply to transactions with associates or friends of the owners, who may in turn provide the owners with commensurate compensation or favors.

As a practical matter, it is clear that loans and loan-like products -- commercial loans, personal loans (including credit card debt), real estate mortgages, etc. -- are highly likely to be deemed appropriate for a bank. Regulators are familiar with them and believe that they can set appropriate capital requirements and judge managerial competence with respect to loans.

At the other extreme, suppose that the XYZ National Bank wants to own and operate a delicatessen. In principle, the Office of the Comptroller of the Currency (OCC) could probably hire restaurant consultants who could advise the OCC on how to judge XYZ's managerial competency in running a delicatessen and what an appropriate capital requirement for owning a delicatessen should be. In practice, it is more likely that the OCC would decide that this is not an area in which it has (or wants to acquire) expertise, and therefore running a delicatessen is not an activity that would be appropriate for a national bank.

However, there is no principled reason to prevent the owners of the XYZ National Bank -- whether as individuals, or as a bank holding company -- from owning and operating a delicatessen. But the relationships and transactions between the bank and the delicatessen need to be on arm's-length terms and would need to be tightly monitored by the OCC, to make sure that these transactions do not become a vehicle for siphoning funds out of the bank and into the pockets of the owners -- e.g., the OCC needs to make sure that the bank does not make under-priced (or hopelessly unrealistic) loans to the deli and/or that the bank does not buy over-priced pastrami sandwiches from the deli for the bank's employees' lunches.

And, of course, the same concepts should apply to the bank owners' operation of any kind of business, regardless of whether that business is a software company, an automobile dealership, an airline, or a forestry company.

It is worth noting that there has been an extensive history of non-financial firms owning savings and loan institutions, through a unitary thrift holding company arrangement, with few problems arising as a consequence.

VI. The Implications.

The implications of the approach that has been outlined above are clear: Any party that is otherwise qualified (e.g., is financially capable, has a sound business plan, and is of good character) should be allowed to own a bank, so long as the bank is adequately capitalized and competently managed, the activities of the bank are restricted to those that are examinable and supervisable, and the relationships and transactions between the bank and the owner are closely monitored by bank regulators.

Consequently, with respect to ILCs, so long as the state that has chartered an ILC and the FDIC can do a good job of monitoring the financial relationships between the parent and the ILC, along the lines described above, ILCs represent a sensible direction for public policy. Indeed, I believe that bank charters generally should be expanded so as to allow non-financial companies to own banks, subject to the restrictions that I have described above.

If it is the Congress's judgment that the FDIC and other bank regulators do not have adequate authority or sufficient capabilities to monitor banks (including ILCs) and their owner/parents in the way that I have described, then enacting legislation to provide the regulators with the necessary authority and/or the resources to develop the needed capabilities is the best response – rather than to prevent these potentially productive ownership arrangements.

As a related matter: It has been suggested by some parties (e.g., the National Association of Realtors) that the issue of non-financial companies' being granted a banking charter and the issue of banks' being allowed to enter the real estate brokerage business are intertwined. They are correct, as a general matter. Both issues raise the general points that are discussed above. And both should be addressed in the same way: Non-financial companies should be granted bank charters, subject to the conditions just described; and, as a matter of policy, banks -- or at least bank holding companies -- should be allowed to enter the real estate brokerage business (with the distinction between whether

banks directly or only bank holding companies are permitted to undertake real estate brokerage, of course, hinging on whether real estate brokerage activities are considered examinable and supervisable by bank regulators).

VII. The Wal-Mart Application and "Unfair Competition"

It is surely no secret that the event that has drawn such extensive public attention to the existence of ILC charters has been Wal-Mart's application to obtain a Utah ILC charter and FDIC deposit insurance for its ILC. Because that application is the "900 pound gorilla in the room", it is worth addressing the Wal-Mart issues directly rather than pretending that they are not important for the ILC question.

The Wal-Mart application has drawn a great deal of attention because of Wal-Mart's success and expansion in general retailing. The opposition and fears do not primarily concern the issues of safety and soundness that have been addressed above. Instead, rival bankers fear that a Wal-Mart Bank may expand at their expense, perhaps with the financial help of the parent; rival retailers fear that a successful Wal-Mart Bank will supplant rival banks and reduce the retailers' supply of credit and thereby disadvantage the retailers. Neither set of fears is likely to translate into a realistic scenario.

First, as is well known, Wal-Mart currently plans to use its bank exclusively as a way of reducing its "back office" financial transactions costs. This use surely cannot generate any of the feared scenarios.

But let us grant Wal-Mart's rivals' worst-case scenario in terms of Wal-Mart's subsequent bank expansions: that Wal-Mart expands its banking operations so as to attract retail customers -- say, through opening retail branches in its stores, and it even opens free standing-branches. What then?

If this is a convenient and efficient arrangement for Wal-Mart and for shoppers, then they

will become bank customers. Rival banks will lose some customers. Some rivals may be unable to compete effectively and will seek merger partners; others will devise new strategies to attract and retain customers.

Will a successful Wal-Mart Bank sweep the countryside clean of all rivals, and will Wal-Mart's retailing rivals thereby be deprived of finance and consequently be at a disadvantage? This seems highly unlikely. The executives of small banks have a history of claiming dire consequences every time a state legislature contemplated allowing expanded intra-state branching privileges during the 1960s, 1970s, and 1980s, and again as the Congress contemplated permitting nationwide branching in the 1980s and 1990s. And, yet, despite today's near ubiquitous nationwide branching possibilities and over two decades of active mergers and banking consolidation, there are still (as of year-end 2005) over 7,500 commercial banks chartered in the U.S., as well as over 1,300 savings institutions and over 8,500 credit unions. Further, despite the consolidation, thousands of new (de novo) banks have been formed over the past few decades, as enterprising bankers have seen and embraced new business opportunities, often in the wake of mergers. Existing banks have extended their branch networks as well. A similar pattern could be expected if an expanded Wal-Mart bank were to leave the financial needs of groups of customers unfulfilled.

America's bankers may not like the competition; but they are creative and resourceful, and most will survive.

Might the parent Wal-Mart subsidize the bank so as to allow the bank to behave in a predatory manner and eliminate financial rivals? First, note that the parent subsidizing the bank is the exact opposite of the usual scenario -- that the parent might try to drain funds *out of the bank* -- that should worry bank regulators. Second, for predatory behavior to be ultimately successful and profitable, the initial period of subsidized behavior must be followed by a "recoupment" period when monopoly profits can be achieved. But if bank charters remain readily available for de novo entrants and branch extensions remain easy to achieve for incumbents, such recoupment is unlikely, which

should discourage any initial attempts at predatory behavior. And third, the U.S. antitrust laws remain as a policy tool for dealing with predatory behavior.

Might Wal-Mart "lean" on its suppliers to use the Wal-Mart Bank as a condition for being allowed to sell their goods in Wal-Mart stores? If the Wal-Mart Bank's terms are otherwise not as favorable for the supplier as the latter's original bank, then Wal-Mart will have to give up something else -- perhaps Wal-Mart will have to accept a higher wholesale price when buying the supplier's goods. And, as a consequence of such "leaning", Wal-Mart's retailing rivals would be that much more attractive to the suppliers as outlets for their goods. Also, such conditioning would bring Wal-Mart under antitrust scrutiny for "tying".

Much of this discussion, and the fears expressed, has the same flavor as those expressed by the securities industry in the 1970s, 1980s, and 1990s, as it opposed the gradual breaking down of the Glass-Steagall barriers that had separated the commercial banking industry from the securities industry since the 1930s. Those fears -- that banks would somehow behave in a predatory fashion toward the securities industry, that banks would somehow decimate and dominate the securities industry, and/or that entrance into the securities industry would somehow weaken the safety and soundness of banks -- all proved to be unfounded. The same would likely be true of the scenarios advanced by Wal-Mart's foes.

In sum, the "doomsday" scenarios of Wal-Mart's rivals seem far-fetched and unrealistic. Such scenarios ought not to be guiding bank regulatory policy.

VIII. Conclusion.

In this statement I have offered a principles-based policy approach to what activities should be permitted for a bank, what activities should be permitted outside of a bank, who should be allowed to own a bank, and how the relationships and transactions between a bank and its owner should be structured and monitored.

This approach has a clear implication for the subject of today's hearing: So long as ILCs are adequately examined and supervised, they represent a sensible direction for public policy. Indeed, bank charters generally should be expanded so as to allow non-financial companies to own depository institutions, subject to the conditions that I have described above. And if the Congress judges that bank regulatory authority or capabilities are not adequate for the job, then the Congress should enact legislation that would strengthen that authority and/or those capabilities – rather than restricting potentially productive ownership arrangements.

Selected Bibliography

Allen N. Berger, Seth D. Bonime, Lawrence G. Goldberg, and Lawrence J. White, "The Dynamics of Market Entry: The Effects of Mergers and Acquisitions on Entry in the Banking Industry," Journal of Business, 77 (October 2004), pp. 797-834.

Lawrence G. Goldberg and Lawrence J. White, eds., The Deregulation of the Banking and Securities Industries. Lexington, Mass.: Heath, 1979.

Bernard Shull and Lawrence J. White, "The Right Corporate Structure for Expanded Bank Activities," Banking Law Journal, 115 (May 1998), pp. 446-476.

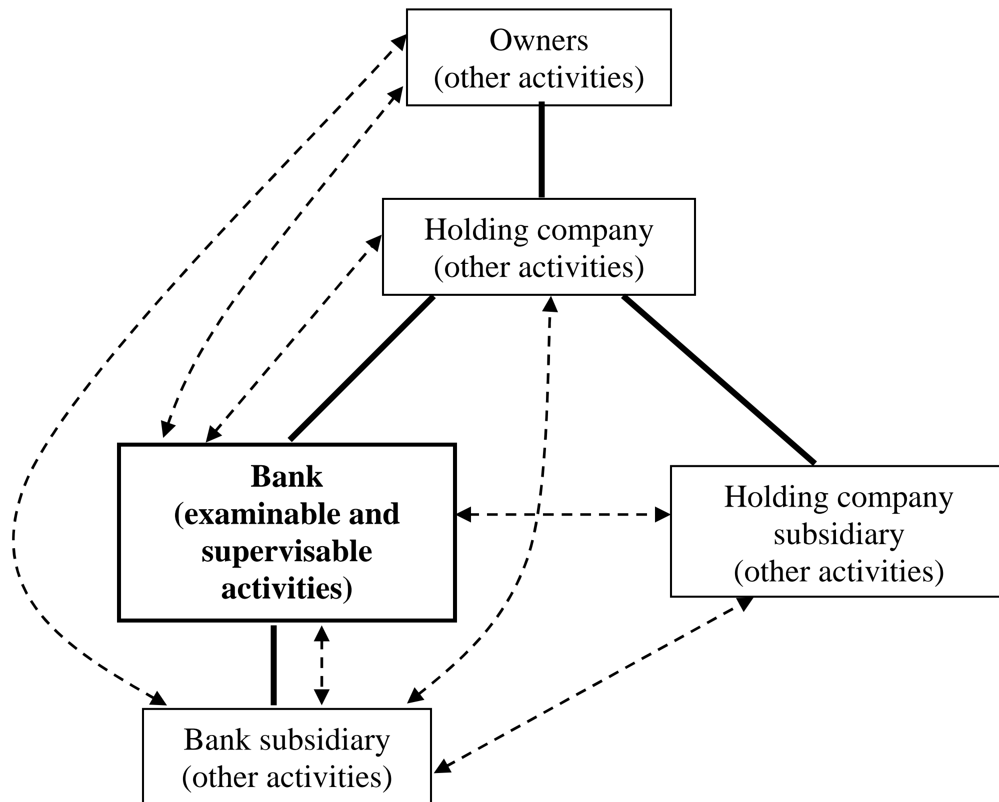
Lawrence J. White, The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation. New York: Oxford University Press, 1991.

Lawrence J. White, "The Proper Structure of Universal Banking: "Examinability and Supervisability," in Anthony Saunders and Ingo Walter, eds., Universal Banking: Financial System Design Reconsidered. Chicago: Irwin, 1996, pp. 682-695.

Lawrence J. White, "What Constitutes Appropriate Disclosure for a Financial Conglomerate?" in Robert E. Litan and Richard Herring, eds., Brookings Papers on Financial Services, 2003. Washington, D.C.: Brookings, 2003, pp. 245-272.

Lawrence J. White, "The Residential Real Estate Brokerage Industry: What Would More Vigorous Competition Look Like?", Real Estate Law Journal, 34 (Summer 2006): 22-42

Figure 1: Stylized Structure of Locations of Appropriate Activities for a Bank and of Other Activities



Lines of ownership

Transactions to be closely monitored