

# Firms' Push to Enter Banking Wins Hill Support

Brokerages and Retailers Would Operate Without Fed Oversight; Greenspan Is Among Critics

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Merrill Lynch, Morgan Stanley, Wal-Mart, General Electric and other companies are gaining support in Congress for the right to set up a nationwide banking system that could compete with commercial banks but operate under looser federal rules.

Consumer groups, bankers, some lawmakers and Federal Reserve Board Chairman Alan Greenspan have sharply criticized the effort, saying it would create a second, parallel banking system that would result in unfair competition and more risk for the federal deposit insurance system and possibly taxpayers.

The changes, contained in two pieces of legislation, one of which has been passed by the House, would enable retailers and manufacturers, such as Wal-Mart and GE, to own full-service banks nationwide, which current law prohibits. They would also allow securities companies to own full-service banks without having to submit to oversight by the Federal Reserve Board.

At issue is whether Congress should expand the power of obscure entities known as industrial loan companies. These state-chartered, limited-purpose banks -- which operate in Utah, California, Colorado, Nevada and Minnesota -- generally specialize in one area, such as offering credit cards. The owners of these companies are not regulated by the Federal Reserve and may include automakers, discount department stores and other firms that are largely unrelated to financial services.

The House Financial Services Committee has passed two bills that would allow the giant Wall Street and retail firms to transform their industrial loan companies into full-blown banks. For example, Merrill Lynch would be allowed to open full-service branch offices around the country that could accept deposits, cash checks and pay interest on accounts for individuals and companies.

One bill, which passed the House last month, would give industrial loan companies the right to offer checking accounts to businesses and to pay interest on that money. These new powers are necessary if industrial loan companies are to compete with commercial banks, executives at securities firms say.

A second bill, passed by the committee this week, would make it possible for industrial loan companies to set up branch offices nationwide without seeking states' permission. Currently they cannot do that in most states.

Greenspan, in a letter to Rep. Michael G. Oxley (R-Ohio), chairman of the House Financial Services

Committee, said the changes "would alter the structure of banking in the United States and be contrary to two important national policies," one prohibiting non-financial companies, such as Wal-Mart, from owning a bank, and one that gives the Federal Reserve responsibility for ensuring that "companies that own federally insured banks operate in a safe and sound manner."

"Industrial loan companies are a loophole that would be greatly expanded by this legislation," Federal Reserve Board governor Donald L. Kohn said in a recent interview. "If they want parity with banks, they should have parity in every respect, and that means their parent companies would be subject to the same rules and regulations the parents of other federally insured banks are subject to. If they were granted the powers they are trying to obtain, they would be treated differently and preferentially relative to other federally insured banks."

The American Bankers Association is against giving the industrial loan companies new powers without Federal Reserve supervision. The Federal Reserve is worried that if the bills become law, companies that have full-service banks, such as Citigroup, might drop their regular bank charters and move their operations into their industrial loan companies to avoid Fed scrutiny, according to Fed sources. Citigroup declined to comment.

Merrill Lynch and Morgan Stanley, which have taken the lobbying lead on the issue, say industrial loan companies are adequately regulated by Utah state regulators and by federal regulators at the Federal Deposit Insurance Corp. FDIC Chairman Donald E. Powell and Utah Commissioner of Financial Institutions Ed Leary agree.

But Greenspan said, in his letter, that there were significant differences in the regulatory authority of the Fed and the other overseers. For instance, the FDIC and the state can only regulate the industrial loan company itself, not the parent. The Federal Reserve is required to examine the financial health of the parent company to ensure that if the non-bank portion fails, it does not plunge the bank into financial problems that would pose a risk to the federal deposit insurance system and ultimately the taxpayer. The Fed, for example, can require the parent company to hold additional reserves as a cushion against potential losses.

Executives at Merrill, Morgan and Goldman say they do not want to be regulated by the Federal Reserve Board, because they think it is overly restrictive. For example, if they are under the Fed, most security companies would have to hold more capital as a potential cushion against loss than they currently have to hold.

Wall Street firms also argue that the legislation would not have a major impact on their industrial loan company operations. A two-page document being circulated to members of the House Financial Services Committee by Merrill Lynch and Morgan Stanley says that industrial loan companies "have long had the authority" to offer checking-type accounts to "both retail and corporate customers."

But regulators with the federal government and in Utah, where Merrill's industrial loan company was

chartered, say that only small industrial loan companies -- those with assets of \$100 million or less -- can offer corporate checking accounts and that it's unlikely giant securities firms would want a bank that small. Under the legislation, industrial loan companies of any size could offer corporate, interest-bearing checking accounts.

Merrill Lynch, which has owned an industrial loan company since 1987, uses it to offer its securities customers federally insured, interest-paying accounts and loans secured by those accounts. As of June 30, 2002, Merrill Lynch's industrial bank, based in Salt Lake City, had assets of \$63 billion. Morgan Stanley has told lawmakers that its Utah-based industrial loan company is a tiny institution. Public records show the industrial loan company has assets of \$2.8 billion.

Goldman Sachs and UBS Warburg have applications for industrial loan companies pending in Utah.

A Wal-Mart spokesman said changes in the industrial loan company rules are the retailer's best hope of getting into banking, given the other rules that bar it from owning a bank. The company wants to offer banking services, because those are the services most frequently requested by customers, said Wal-Mart spokesman Jay Allen. "Our fixation is not on getting a bank, but on giving our customers what they want," he said.

Wal-Mart for years has been offering money orders, money transfers and paycheck cashing, and at cheaper prices than competitors, Allen said. The company also has leased in-store space to local banks at 784 stores, but hundreds of its stores can't find a bank to partner with.

"The issue for us is providing affordable, everyday prices for financial services to our customers and our employees, with a particular interest in serving those who aren't served by anyone else, the so-called unbanked," Allen said.

Critics say the issue for them is potential conflicts. "Without proper oversight, a commercial company might be tempted to use an industrial bank as a personal piggy bank and endanger the safety and soundness of the bank," said Travis Plunkett, legislative director of the Consumer Federation of America.

The current situation dates to 1999, when Congress passed the Gramm-Leach-Bliley Act. It deregulated the financial services industry by allowing securities and banking to exist under one roof as long as the Federal Reserve oversaw the parent company.

The law also closed loopholes that had enabled non-financial companies, such as Ford Motor Co., to own banks, leaving industrial loan companies as the only way for non-financial companies to enter banking.

An exception was made for industrial loan banks because they were generally small and engaged in limited banking activities.

Utah has chartered 24 of the 53 industrial loan companies in the country, more than any other state.

California and Colorado, which have chartered 19 and five, respectively, have barred non-financial firms from owning an industrial loan company, citing historic separation of commerce and banking in the United States. California's decision was triggered by an application from Wal-Mart. Nevada is debating the commerce and banking issue.

The idea of expanding powers for industrial loan companies has strong support in the House, where supporters say these other companies have a right to compete with banks on an equal footing. Critics are hoping for a compromise. Rep. Barney Frank (D-Mass.), the ranking Democrat on the House Financial Services Committee, said he was working with Oxley to narrow the law by barring industrial loan companies owned by non-financial service corporations, such as Wal-Mart, from enjoying the expanded new branching powers that industrial loan companies owned by securities firms would enjoy. It's unclear whether GE also would be barred. Oxley's staff did not return repeated telephone calls and e-mails.

Rep. Jim Leach of Iowa, the former chairman of the House Financial Services Committee and now its second-highest-ranking Republican, opposes the legislation and is concerned about its impact. "Seldom have I known of a greater power play more against the public interest than that being contemplated in these bills. It reduces supervision of the financial sector at precisely the time that dangers to the financial system are merging in unpredicted ways."

The legislation may have a tougher time in the Senate. Although Sen. Robert F. Bennett of Utah, the No. 2 Republican on the banking committee, strongly supports the measures, Chairman Richard C. Shelby (R-Ala.) has, in the past, been an advocate of separating commerce and banking. He has not indicated his position on the new effort. Sen. Paul S. Sarbanes of Maryland, the committee's ranking Democrat, strongly opposes it.

Plunkett said it was ironic that Merrill Lynch, Morgan Stanley, Goldman Sachs and UBS were pushing to expand the power of industrial loan companies -- and are embracing the state of Utah as a primary regulator that could help set national bank rules.

Last month, these firms were among 10 Wall Street firms that paid \$1.4 billion to settle state and federal charges that they had cost individual investors billions of dollars by issuing inaccurate, overly rosy stock research reports to win investment banking business. These firms continue to decry a probe by New York state that led to the settlement because they say state officials should not be setting rules for a national and global industry.

"We think it's a particularly bad idea that the companies pushing this are investment firms: Given everything we know about how poorly investment firms have handled conflicts of interest in recent years, why would we make it easier for them to skirt federal restrictions?" Plunkett said.