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On the Issues

The Wal-Bank Principle

By Peter J. Wallison

In opposing Wal-Mart's application to acquire a bank-like institution in Utah, the banking industry is hurting its own prospects for growth and expansion.

At the Federal Deposit Insurance Corporation's (FDIC) recent hearings on Wal-Mart's application to acquire a bank-like institution in Utah that can accept FDIC-insured deposits, a representative of the National Association of Realtors testified that such an acquisition would violate the principle separating banking and commerce. No doubt the banks savored this rare support from the realtors, but what they may not have realized is that the joke is on them.

For more than five years, the realtors have tenaciously fought a Washington-style, lobbyist-intensive battle against allowing banks into real-estate brokerage. What was their argument? You guessed it—the need to maintain the separation of banking and commerce. So the banks trying to prevent Wal-Mart from entering their business and the realtors hoping to avoid competition from banks are both citing the same "principle." This should tell us a lot about what the separation of banking and commerce is really about.

In the early 1980s, led by Walter Wriston of Citicorp, the banking industry was fighting to gain access to the securities and insurance businesses. These industries fought back, citing the Glass-Steagall Act and restrictions in the Bank Holding Company Act to demonstrate that Congress had always followed a policy of separating banking from commerce. The banks argued that the separation was obsolete, that banking laws and regulations now prevented any abuse that might arise from such relationships, and that business and consumers would benefit from increased competition in securities and insurance.

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The fight went on through the Reagan, George H. W. Bush, and Clinton administrations with no appreciable change in conditions, until Sandy Weill of Travelers Insurance and John Reed of Citibank decided to force the issue. Their 1998 agreement to merge, creating today's Citigroup, put Congress in the position of either changing the restrictive laws that applied to bank affiliations or unwinding a major financial conglomerate. The result was the Gramm-Leach-Bliley Act of 1999, which ratified the merger and allowed banking organizations to affiliate with companies engaged in financial activities such as securities and insurance underwriting.

In effect, the act also eliminated any policy foundation for the separation of banking and commerce. Separation had always rested on the notion that an affiliation between a bank and a company that was a user of credit—i.e., a commercial firm—could distort the credit-granting process. But in permitting affiliations between banks and securities firms—major users of bank credit—Congress apparently decided that banking laws and regulations, as well as the highly competitive financial markets that had developed by the late 1990s, had eliminated the dangers in the credit-supplier/-user relationship.

The banking industry should have taken this as the basis for achieving further deregulation,

particularly the lifting of rules that confined its activities to those the Federal Reserve determines are financial in nature. But as shown by the industry's reaction to the Wal-Mart application, it has not taken this approach, continuing instead to invoke the separation principle as a defense against competition.

The Banking Industry Weakens Its Own Case

The results of this shortsighted strategy are easily seen in the banks' fruitless effort to enter the real-estate brokerage business. For five years, the Fed, under pressure from Congress and the realtors, has been unable to decide whether real-estate brokerage is a financial activity and thus permissible for banking organizations. The banks are outraged by this delay—and they should be; but they do not seem to see either the link between the separation idea and the realtors' successful defense, or the conflict between their opposition to Wal-Mart's entry into banking and the realtors' opposition to their entry into real-estate brokerage.

The banking industry is looking backward, not forward. As the only U.S. industry still subject to restrictions on cross-industry acquisitions, banking organizations should favor the elimination of regulatory restrictions on entry into banking, not their continuation. The way to get into real-estate brokerage is not to oppose Wal-Mart but to oppose the restrictions that keep banking organizations out of activities in which they could improve conditions for consumers. Instead of bemoaning "loopholes" in the separation of banking and commerce, the banks would be well advised to welcome Wal-Mart and use its competition as a basis for breaking down the limitations on bank activities. The lesson of the Travelers-Citigroup merger, after all, is that regulatory barriers can be eliminated by forcing Congress to confront market realities.

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The greater lesson here—one that Walter Wriston saw—is that industries that rely on regulation to protect them from competition build a coffin instead of a wall. In our dynamic and innovative economy, regulation is a double-edged sword. While it might confer some temporary protection from competition, in the long run it isolates the regulated industry from the realities and opportunities of the marketplace. In its reaction to the Wal-Mart application, the banking industry is following in the footsteps of industries that relied on regulation to protect them from competition—the railroads, the airlines, and the old AT&T. And this is a well-worn path to decline.

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