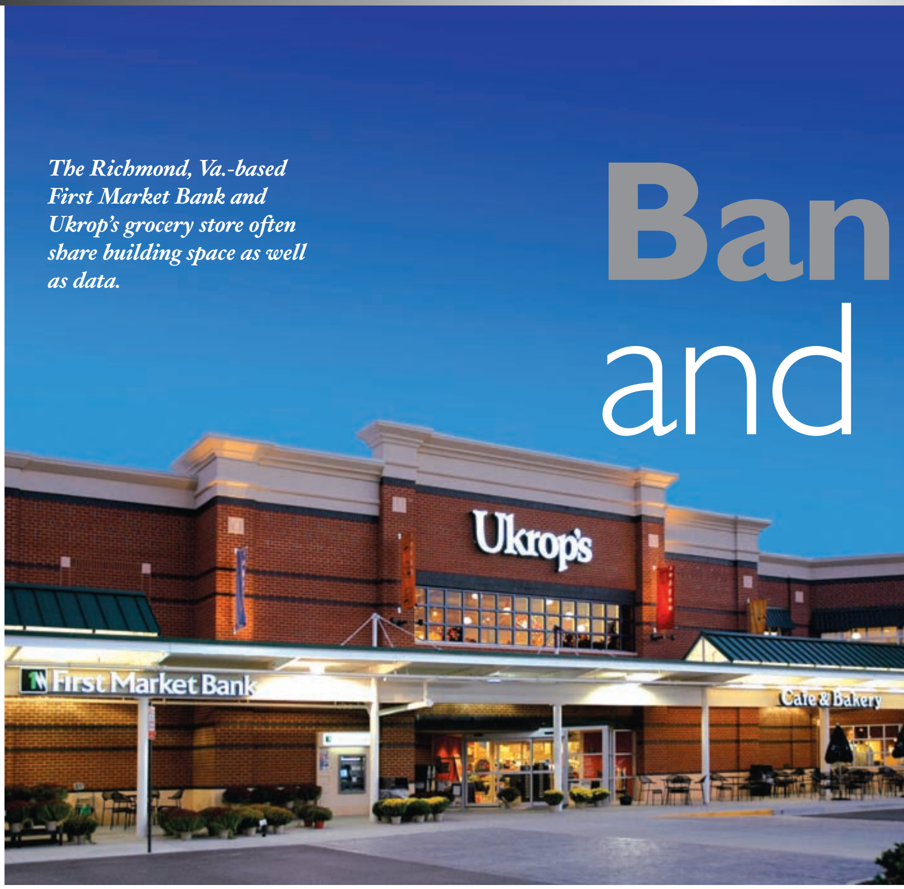

The Richmond, Va.-based First Market Bank and Ukrop's grocery store often share building space as well as data.

Banks and Business

The success of some banking and commerce combinations raises the question of whether maintaining a wall between them makes economic sense

BY DOUG CAMPBELL

A lot of companies describe themselves as one of a kind, doing things that their competitors don't, or can't. In the case of First Market Bank, some of those claims are 100 percent accurate.

First Market is majority-owned by the Richmond, Va.-based supermarket chain Ukrop's and its founding family. Ukrop's got into the banking world in 1997, two years before the loophole allowing it closed. Under current law, this arrangement is forbidden, except for those grandfathered in. Today, First Market is the only thrift in the nation owned by a grocery store, and one of just 13 overall whose owners engage in nonbanking or nonfinancial activities.

Thanks to this unusual relationship, First Market branch managers can (and do) meet each week with Ukrop's store managers, sharing ideas and information. The bank swaps data on its customers with the food store, and vice versa. Ukrop's shoppers who open an account with First Market get a discount on groceries. All of these activities help boost the bottom line, according to First Market and Ukrop's.

Even if Ukrop's didn't own First Market, it could engage in these activities. Doing so would simply require contracts between the bank and its commercial affiliate. But contracts of this ilk are tricky to write and consequently rare. Certainly, bank branches housed in grocery stores are far from uncommon. But the level of coordination and information-sharing that goes on between Ukrop's and First Market is quite uncommon.

"We are very much tied to Ukrop's," says David Fairchild, First Market's chief executive. "Our whole strategy has been to be a part of their market and footprint." It is no surprise that 98 percent of First Market's retail customers are also regular Ukrop's customers.

It's been a profitable relationship. First Market now has 34 locations — 24 of them inside Ukrop's stores in central Virginia, the other 10 freestanding branches. That is more locations than for any other bank opened in Virginia since 1995. About 75 percent of its deposits are from retail customers, while 60 percent of its loans are to businesses. In 2006, net income was $9.6 million.

The potential benefits that can be reaped from Ukrop's-First Market-type combinations have prompted many commercial enterprises to seek entry into banking. With the thrift loophole closed, the remaining way for a regular business to gain banking powers is with a so-called Industrial Loan Corporation, or ILC, charter. High-profile applicants for ILC status have included Wal-Mart and Home Depot.

Originally set up as small companies to lend money to industrial workers, ILCs have evolved since their introduction in the early 20th century. Today, they have almost all the same powers as regular banks — they can gather deposits and lend them out to individuals or businesses, among other activities. Most important, perhaps, is that their deposits are insured. Because of this, banking and commerce combinations may pose risks to the economy. The potential for such risks, as well as some other concerns, was a leading reason why regulators last year imposed a moratorium on ILC approvals. Their concern is that the federal banking safety net will be stretched too wide if it covers the potentially risky activities of commercial operations.

PHOTOGRAPHY: COURTESY OF UKROP'S

This is an important worry. With the effects of recent financial market deregulation becoming easier to see, it may be worth exploring the question of whether the wall between banking and commerce has outlived its usefulness.

Deposits on Aisle 6

The story of First Market Bank illustrates many of the reasons why commercial firms might be interested in owning a bank. In the mid-1990s, banks were opening scores of branches inside of grocery stores — there were 4,800 such arrangements in 1997, with actual in-store branches, not just ATMs. Doing so was cheaper than building freestanding branches, and it provided an instant pool of potential customers.

Ukrop's entertained many proposals from banks to lease space in its stores. The grocery chain was dominant in its central Virginia footprint and interested in a rental fee that went up or down as a percentage of branch receipts, but most banks were offering only flat rent. The most intriguing offer came from National Commerce Bancorporation, a Memphis-based bank that has since been acquired by SunTrust. National Commerce proposed that Ukrop's take a 51 percent ownership stake in a new concern, with the bank taking the rest, a proposal that Ukrop's accepted. (First Market is actually a thrift, meaning it is supervised by the Office of Thrift Supervision but otherwise keeps virtually all the same powers as commercial banks.)

The Bank Holding Company Act of 1956 prohibited almost all banking and commerce combinations. But the law didn't apply to savings banks. Under the Savings and Loan Holding Company Act of 1967, entities called "unitary thrift holding companies" could do what their name implied — own a single savings bank while engaging in a wide variety of nonbank activities. It wasn't until the Gramm-Leach-Bliley Act in 1999 that, going forward, unitary thrift holding companies were stripped of their commercial powers. In addition, unitary thrifts lost their ability to engage in nonbank activities if they were bought. (At the same time, banks and providers of other financial services, such as securities brokerages and insurance firms, were given the ability to merge.)

In 1997, the unitary thrift loophole allowed Ukrop's to gain something it couldn't through a traditional contract: control. "Having ownership, they could control how they do things," says First Market's Fairchild. "The ownership piece helps the bank look a lot like what they want their customers to experience in a normal shopping situation ... Over time, they could get a better return but mainly they could control the quality of the customer service experience."

In 2005, SunTrust acquired National Commerce and then sold its interest in First Market. Today, First Market is owned 49 percent by Ukrop's Super Markets, 11 percent by members of the Ukrop's family, and the remaining 40 percent by a Richmond-based insurance firm called Markel Corp. Throughout all the ownership changes, the institution itself has been operated as First Market Bank.

It's not unusual to find First Market representatives combing the aisles at Ukrop's stores, manning the sampling stations and handing out pamphlets or chatting up potential customers. Its 10 freestanding branches are all within a few miles of a Ukrop's store, and it's safe to say that anybody who banks at First Market is aware of the relationship. "To take the brand beyond Ukrop's is not something we're quite ready to do yet," Fairchild says. "We're hooked up with probably the most important brand in this marketplace. So why would we want to go beyond that?"

The Ukrop's-First Market pairing demonstrates the sort of efficiencies that economists have long posited as those most likely to be reaped in banking and commerce combinations. Yes, many of the "synergies" that Ukrop's and First Market have could be accomplished with contracts, keeping the firms separate. But with combinations, there may be opportunities to both reduce operating costs and to improve information flows such that profits are greater.

On operating costs, obvious sources of savings are in back-office operations and in joint marketing efforts. But these may be dwarfed by the marketing synergies. Ukrop's managers, for example, are knowledgeable about how to attract and retain customers to their stores. So by extension, they are the most knowledgeable in marketing to First Market's customers — whose target market is the same as Ukrop's. This represents a potential cost savings — Ukrop's managers can share their expertise in reaching the Ukrop's sort of customer with First Market managers — adding to the other obvious cost savings of putting bank branches in convenient, in-store spots. It would be difficult, if not impossible, to rent out this sort of knowledge to banks without running into problems like trade secrets and appropriate compensation.

"Information that a commercial company gathers by doing business with its customers can be passed on to the bank and used by the bank to offer valuable services to the customers of the commercial company, and vice versa," says John Walter, an economist with the Federal Reserve Bank of Richmond who has studied banking and commerce issues. "That's the basis for allowing these combinations. It's easier information-sharing of one kind or another."

In other words, widespread combinations of banking and commerce could prove beneficial to the economy. So why don't we see more of them?

Shaky Business?

While the benefits of banking-commerce partnerships are a bit intangible and slippery, the potential costs are fairly clear-cut. The first is the potential conflict of interest. Consider a hypothetical scenario in which a bank owns a hardware store in a small, rural town. What if the bank refused to lend money to potential rivals to its hardware store? Further, the bank could provide cheap loans to its hardware store's suppliers and customers.

Now, this scenario might be unrealistic in some settings. As San Francisco Fed economist John Krainer put it: "Firms being discriminated against must not have alternative sources of finance." For lending discrimination to occur, the bank would have to be just about the only one in town. There are only a few such places in the United States today, and with the advent of alternative sources of financing beyond banks, it's hard to imagine how a banking and commerce combination would be able to sustain discriminatory practices.

The greater risk, the one that policymakers pay the most attention to, is the threat to the federal safety net. The Federal Deposit Insurance Corp. covers depositor accounts up to $100,000. The very existence of the safety net makes banks safer places to park money. Because of this, insured banks can raise funds at lower rates than other commercial enterprises.

The existence of the deposit insurance protection means that we run the risk of having too many resources flowing to businesses that are associated with banks, and too few to those that aren't. Creditors, for example, might view such firms as safer because of their bank-backing and the safety net that goes with it. Creditors assume that, should a commercial affiliate of a bank get in trouble, then the loss could be shifted to the bank — whose funds are largely insured. This has the effect of widening the federal safety net, as the deposit protection essentially seeps out to commercial business. Federal law makes much loss-shifting illegal, but the potential still exists and creditors know it.

It's one thing for banks to have this moral hazard problem of insured deposits, but quite another for it to extend to commercial firms. "Observers have pointed out that deposit insurance grants an option to banks, and when a bank is close to default, the way to maximize the value of this option is to increase risk," economist Krainer writes. "Commercial ventures provide a host of ways for firms to increase risk."

Of course, examiners keep track of bank operations for the very reason that deposits are insured. These examiners are adept at monitoring financial operations — even nonbank financial operations — but not as skilled when it comes to commercial ventures.

Reconsidering ILCs

All of these cautionary flags have been raised over the past few years as several large commercial firms applied to start or acquire industrial loan corporations. At present there are 61 ILCs, with 18 of those being owned by commercial parent companies. Many of them exist to serve the businesses of the parent companies, like BMW Bank of North America, which provides auto loans. (The Federal Reserve has no jurisdiction over ILCs, as firms can own them without the need for a bank holding company, which the Fed does regulate.)

Wal-Mart applied for an ILC charter in Utah in 2005, saying it intended mainly to use the powers in processing debit and credit transactions. The retailer recently withdrew its application after the FDIC declared a moratorium, which is now to extend into 2008, on ILC applications as the FDIC stepped back to study whether "there are emerging safety or policy issues involving industrial banks."

Some of the loudest protests to ILC expansion came from community bankers. In 14 pages of testimony this April, the chairman of the Independent Community Bankers of America, James Ghiglieri, spoke at length on the potential systemic risks that ILCs operated by the likes of Wal-Mart or Home Depot pose to the economy. It wasn't until page nine of his comments that Ghiglieri addressed a leading suggestion of why community bankers might oppose big ILCs: that they fear Wal-Mart will use its size to virtually take over some banking markets. In his testimony, Ghiglieri denied that implication.

"It would be absurd to assert that community banks seek to close the ILC loophole because they fear competition. Community bankers welcome competition," Ghiglieri says. "To suggest that community bankers are afraid of competition is uninformed, unwarranted, and only diverts attention away from the real policy issues."

But do community banks have anything to fear from Wal-Mart's — or any other large companies' — entry into their realm? According to a recent study, maybe not. Wal-Mart had bank branches in more than 1,000 of its stores as of 2006, with occupants including SunTrust and First National Bank of Texas. Researchers with the Federal Reserve Board of Governors recently studied how well those bank branches were performing. If they were doing very well, for instance, that might offer some evidence that allowing Wal-Mart into banking could eventually drive community banks out of business.

It turns out that, in terms of deposits, branches in Wal-Marts located in major metropolitan markets fare no better than other branches. However, banks that enter some rural areas with in-store Wal-Mart branches see an increase in their deposit market share relative to opening other branches. This suggests that banks in rural areas would be most likely to experience the strongest competition from Wal-Mart branches. Of course, these are branches of banks that are unaffiliated with Wal-Mart, so perhaps the efficiency gains that Ukrop's enjoys with First Market may not be in play in this study.

Wall-Power

Even with the wall between banking and commerce still standing, more and more businesses are finding ways to get into financial services, if not outright banking services. Cincinnati-based Kroger recently announced it would roll out personal-finance services throughout its 2,400 stores, branded under the Kroger name. Customers can obtain home-equity loans, insurance, and credit cards, among other offerings. Of course, customers still need to visit an actual bank branch — whether in-store or not — to open a checking account. Wal-Mart offers its own credit card and has alliances with money transmitters and check cashers.

First Market's Fairchild is ambivalent about whether Wal-Mart should be granted full-fledged entry into banking, perhaps because of the same self-interests that all community bankers have about such a scenario. Wal-Mart's "colossal" size and ability to dominate markets poses problems that the Ukrop's-First Market combination doesn't, at least for now, he says. "Personally, I'm not sure I'd be an advocate to say let's break down the barriers to Gramm-Leach-Bliley. But there are situations where it could work and ours is one of them," Fairchild says. "It's kind of hard to make the leap that, gee, it works for us, couldn't it work for anybody else?"

Let us agree that the combinations of banking and commerce can pay dividends — for shareholders, customers, and possibly the economy at large. Equally, risks accompany these combinations, particularly with the potential for loss-shifting. For market-oriented economists, the banking and commerce wall is thus something of a puzzle. Instinctively, they are skeptical of regulations that might hamper the ability of the economy to function as efficiently as possible. But most accept the reality of deposit insurance and the stepped-up oversight that goes with it in the banking world.

The big question is whether the expected costs of expanding the safety net outweigh the expected benefits of allowing those combinations. Unfortunately, no conclusive empirical evidence exists on that question. So until then, many banking economists think that the wall should remain standing — just to be safe.

"I like to minimize the amount of the economy that has a government safety net under it," economist John Walter says. "I like restrictions that keep the safety net as small as possible, and this seems like one of them. For that reason, at a gut level, I'm against combinations of banking and commerce." **RF**

Readings

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