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AMERICAN BANKER

Hold the Champagne on GE Capital's Breakup

By Mehrsa Baradaran
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General Electric announced last week plans to sell off the bulk of its financing arm, GE Capital. Some have claimed that this move is a win for regulators trying to curb "too big to fail" conglomerates and suggested it's a sign that financial reform is working.

I'm not so sure. I think it just means that the conglomerates left standing are now even more homogeneous and risk-prone.

GE Capital was a Utah-chartered industrial loan company. ILCs, through a variety of legislative loopholes and a quirky history, are bank-like entities that can be owned by nonbanks or by commercial firms.

Ten years ago, Wal-Mart famously attempted to charter an ILC, and all hell broke loose. An unusual consortium of banks, nonbank lenders, and community groups joined forces to oppose the proposal. Many decried the unholy alliance of a commercial giant and a bank as exactly the sort of thing that regulation should be aimed at preventing. The media firestorm ended in Wal-Mart's withdrawn application and a Federal Deposit Insurance Corp. moratorium on any new ILC charters.

At its peak in 2006, the ILC industry had a total of $200 billion in assets. It was a fascinating frontier, allowing nonbank financial firms to encroach into the heavily guarded world of banking.

In retrospect, ILCs seem to have served as a springboard for so-called shadow banks to become full-fledged bank holding companies. The largest ILCs were owned by Merrill Lynch, UBS, American Express, Morgan Stanley, Lehman Brothers, General Motors and GE. Of the 20 largest ILCs in 2006, only four had non-financial companies as parents: GE, GM, Volkswagen and BMW Group.

Today, the nonbanks once on the edge of the commercial-banking divide are now firmly on the banking side. Most of the companies on the list, with the exception of Lehman Brothers, are now financial giants comfortably labeled as "banks" in the post-Dodd-Frank era. Even the General Motors Acceptance Corp. is now called Ally Bank and has been designated as a systemically important financial institution.

Volkswagen divested its bank during Porche's failed attempt to acquire the company. Now that GE is selling, BMW is the only commercial firm with a large ILC. Target, Harley Davidson, Volvo and Toyota still own ILCs, but they're much smaller.

This is good news for those who are strong proponents of the bedrock principle of the separation of banking and commerce. However, this may not be great news for those concerned about TBTF firms in finance.

GE is getting rid of GE Capital in order to reduce the risks the company posed to GE's bottom line. But the majority of the unit is expected to be bought by other large financial firms. Private equity firm Blackstone Group is buying most of GE Capital Real Estate, while Wells Fargo is buying some of the unit's performing loans. *The Wall Street Journal* reports that Citigroup and PNC Financial Services could be potential buyers for GE's commercial lending and leasing business.

The risks involved in GE Capital still exist. But those risks will be squarely in the financial world. This doesn't make banking any less risky, just more concentrated.

It's also worth questioning whether the separation of banking and commerce necessarily leads to safer banks. I don't think so. Why is a homogeneous banking sector less prone to risk than a more diversified structure that allows commercial firms to own banks?

GE Capital and GM each offer cautionary tales about what might go wrong in this scenario. The banks owned by both firms got so big that they dominated the parent company's core commercial business.

But ultimately, perhaps systemic risk could be reduced if well-capitalized commercial firms like Wal-Mart and Home Depot owned ILCs and shored up their banks in the event of a crisis. Because their core business is not tied to the financial markets, they could offer a buffer to financial panic.

Bank holding companies are meant to serve as a "source of strength" that can act as a similar buffer in a crisis. But today, most bank holding companies are mere shells with no assets of their own. The only backstop with adequate liquidity, in the event of financial contagion, is the Federal Deposit Insurance Corp. insurance fund, the Federal Reserve, and ultimately the taxpayer.

That's the problem with too big to fail. The government is the only entity that can be a source of strength for troubled banks. But commercial giants can fail (unless they are automakers in swing states). This means they can suffer market discipline much more than large banks can.

GE was probably smart to get rid of GE Capital. The market certainly thinks so, given that the company's stock has surged in response to news of the sale. But I am skeptical that this move means that financial reform is working or that it signals the end of TBTF banks. It just means that risky assets are being shifted back into the largest banks. It may also mean that the ILC, having served its purpose of providing a gateway for shadow banks to become banks, is finally dead.

Mehrsa Baradaran is an associate professor of law at the University of Georgia and author of the forthcoming book How the Other Half Banks *with Harvard University Press. Follow her on Twitter @MehrsaBaradaran.*

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