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Industrial Loan Companies

Supporting America's Financial System

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Executive Summary

"The ILC charter has proven to be a strong, responsible part of our nation's banking system. ILCs have offered innovative approaches to banking. Many have contributed significantly to community reinvestment and development."

FDIC chairman Sheila C. Bair
Testimony before the U.S. House of Representatives
April 25, 2007

Should commercial firms be prohibited from owning banking institutions? Should the United States remain the only G20 country opposed to the "mixing of banking and commerce"? Should officials block a safe, sound, and well-capitalized segment of the banking industry from expanding?

These questions have assumed new urgency as the nation struggles to recover from the worst economic downturn since the Great Depression while addressing major disruptions in its credit markets. Ensuring the availability of adequate credit to businesses and consumers is crucial to boosting economic growth. Financial and nonfinancial companies alike could help in this regard if allowed to invest in the nation's banking system—whether to serve their own customers and or to launch stand-alone operations.

It's worth recalling that General Motors and Ford, for example, helped revive the banking industry during the Great Depression when they assisted in recapitalizing the two largest banks in Michigan. This kind of broader assistance is not possible today because existing laws (first enacted in the 1950s) do not allow companies to own most types of banks unless the consolidated entities *only* engage in banking and other financial activities.

The type of banks that companies with more diverse activities can own has been subject to a moratorium on new charters since 2007. Prior to the moratorium, a handful of states approved charters that allowed diversified companies to invest in banks, contributing to the availability of credit (albeit on a limited scale). These banks are known as commercially owned ILCs,[1] and they have operated successfully during the past 20 years without a single institutional failure.[2]

Understandably, other companies have also expressed an interest in deploying available capital into the banking industry by obtaining charters to operate ILCs, but some voices (both within and without the banking industry) have urged caution. There is a growing debate over whether prohibitions in the Bank Holding Company Act (BHCA) should be repealed, retained as is, or strengthened. In short, should the U.S. allow the future expansion of commercially owned ILCs?

This study aims to help policymakers better understand the dynamics of the modern credit markets and the safeguards that could allow legitimate, capable businesses to deploy capital into the banking industry. ILCs are subject to all the same rules, regulations, and taxes as commercial banks. Many of the firms that would be logical candidates for establishing ILCs have credit programs that are already developed and proven. In fact, some have major financial operations, including insurance, commercial finance, and consumer finance. The development of the ILC industry has been driven mostly by the desire of various companies to organize bank subsidiaries to run an existing financial operation in a more reliable and cost-effective manner, or to develop new financial programs

1. Industrial loan companies (ILCs) are also known as industrial banks. There are two ILC ownership models: For purposes of this study, **a commercially owned ILC** is one whose parent or affiliates engage in activities other than banking, insurance and securities. A **financially owned ILC** is owned or controlled by a company that only engages in financial activities, similar to a financial holding company.
2. Two *financially* owned ILCs failed in the recent downturn. One was a California-based ILC that was structurally similar to the kinds of community banks that failed in large numbers during the downturn. It specialized in real estate lending in a local market, and was impacted by the decline in real estate just like other community banks in that state. The other was a financially owned ILC in Utah that specialized in small business credit cards. That customer group was also heavily impacted during the downturn. The FDIC classifies the California-based ILC as a voluntary closure, whereas the Utah-based ILC is classified as a failure. Nevertheless, some have suggested to us that the California-based institution was a failure.

that complement their other business lines. All the available evidence suggests that these efforts have been conducted in a safe and sound manner to date.

Consider the following facts on the comparative financial performance and strength of industrial loan companies (all based on FDIC data for the third quarter of 2010):

- ILCs in the aggregate have a significantly higher ratio of capital to assets (16.7 percent) than the banking industry as a whole (11.3 percent).
- ILCs have a significantly lower percentage of troubled assets (15 percent) than the banking industry as a whole (31 percent). Commercially owned ILCs in particular have the lowest percentage of troubled assets of all banks (2.35 percent).
- These institutions are significantly and consistently more profitable, with a higher return on assets (2.18 percent), than the banking industry as a whole (0.56 percent). As a group, commercially owned ILCs are the most profitable banks in the nation (with a 2.97 percent ROA).
- ILCs are routinely examined by state and federal regulators in the same manner as other types of banks, and have proven to be no more likely to fail.

This track record underscores the strength of the industry, even after absorbing the impacts of the financial crisis and the recession. Performance figures for a longer period are generally even more impressive. At the very least, the business model that produced this history of safe and sound operations during good and bad times alike merits further study and consideration.

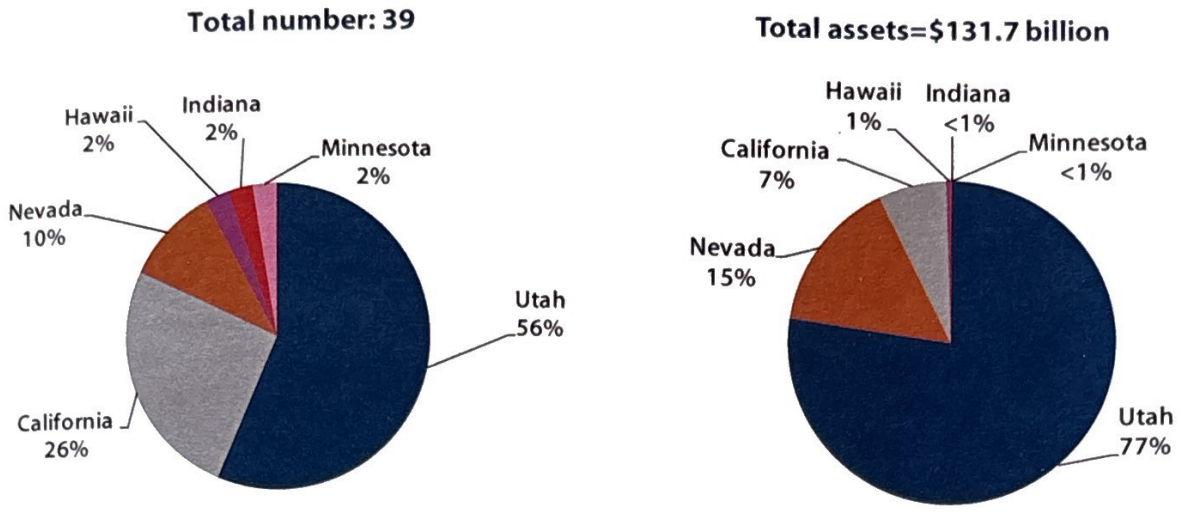
The Industry's Evolution

As a type of banking charter, ILCs have been around for a century; they actually pre-date the establishment of the Federal Reserve in 1913. Their names are a nod to their original mission: lending to industrial workers who had difficulty obtaining credit elsewhere. But over time, as the financial marketplace changed, ILCs evolved into more modern financial institutions offering a greater variety of financial services to a broader customer base.

The ILC industry has never been very large in terms of number of institutions or total assets—and it has always been dwarfed by the traditional banking industry. Nationally, in 1920, there were 87 ILCs with $31 million in total assets, compared to about 30,000 commercial banks holding nearly $50 billion in total assets. The ILC industry experienced rapid growth after the 1930s, reaching a high of 254 institutions with $408 million in assets in 1966. But as of mid-2010, there were only 39 ILCs offering federally insured deposits to their customers. With $132 billion in total assets, these institutions represent only about 0.5 percent of the total number of FDIC-insured institutions and roughly 1 percent of the total assets of all the insured institutions.

In the early years of the industry, at least 40 states chartered or licensed ILCs. As of mid-2010, however, only six states still had active FDIC-insured ILCs, with Utah far outranking all others in terms of both number of institutions and total assets. ES figure 1 illustrates Utah's dominance. Utah and Nevada by far are the two most important states in today's ILC industry.

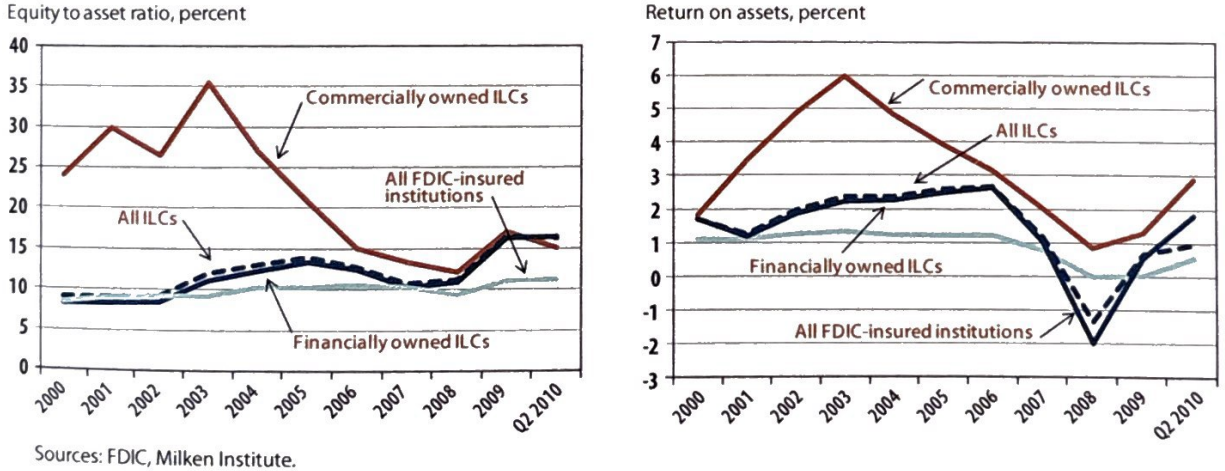
ES figure 1. State distribution of ILCs by number and assets, Q2 2010



Note: This excludes ILCs that do not take deposits.
Sources: FDIC, Milken Institute.

As of mid-2010, ILCs owned by companies engaged in commercial activities (often in addition to financial activities) accounted for only 14 percent of the industry's total assets. Nevada and Utah were the only two states with active commercially owned ILCs over the past decade, with the vast majority chartered in Utah. And though they are a small segment of the broader banking industry, commercially owned ILCs were the best-capitalized type of bank in the nation throughout most of the past decade as compared to the other types shown in ES figure 2. In addition, ILCs performed far better than other banks in terms of return on assets (ROA) throughout most of the decade (and again, commercially owned ILCs, specifically, posted the best performance).

ES figure 2. ILCs and banks: Financial performance, 2000 to Q2 2010



Sources: FDIC, Milken Institute.

Since the first ILCs were small, not all offered deposits, and they catered to a narrow group of customers, these early institutions essentially operated like local consumer finance companies—and they were hardly considered real competition for banks. But that equation started to change during the 1930s, when the FDIC was established in response to numerous bank runs and associated failures. In 1934, the FDIC decided to insure the thrift certificates of 29 ILCs, and thereafter added ILCs to the ranks of insured financial institutions on a case-by-case basis. Over time, more states began allowing ILCs to offer both demand and time deposits. Then, with the passage of the Garn-St Germain Act in 1982, all deposit-taking industrial loan companies became eligible for federal deposit insurance. California, Colorado, and Utah responded by enacting state laws requiring deposit-taking ILCs to obtain FDIC insurance. In the Competitive Equality Banking Act (CEBA) of 1987, Congress provided for an express exemption for owners of FDIC-insured ILCs chartered in states that required FDIC insurance as of that date.

Throughout most of the industry's history, ILCs were either stand-alone institutions or their parents were financial firms. In 1988, however, General Motors acquired an ILC charter. Many other commercial firms, including BMW, Volkswagen, Toyota, General Electric, Target, Pitney Bowes, and Harley-Davidson, subsequently formed ILCs in Utah or Nevada without any significant political controversy.

But in 2005, Wal-Mart filed an application with the Utah Department of Financial Institutions and the FDIC to form a new ILC, igniting a firestorm of protest. The FDIC placed a moratorium on new ILC applications in 2006, and held two public hearings on Wal-Mart's application—the first such proceedings in the agency's 78-year history. More than 12,600 comment letters flooded the FDIC, mostly arguing against Wal-Mart's plans. Our research finds that by 2007, California, Colorado, Illinois, Iowa, Kansas, Maine, Maryland, Missouri, Oklahoma, Texas, Wisconsin, Virginia, and Vermont had passed laws restricting the operation of ILCs to various degrees. Wal-Mart ultimately withdrew its application in March 2007, before any decision had been rendered by the FDIC.

Some banks and trade associations opposing Wal-Mart's banking plans pressed their case by pointing to the "historical" policy in the United States against mixing banking and commerce. But in actuality, laws limiting commercial ownership of a bank were first enacted in 1956 and applied to only a certain type of bank. Commercial ownership of a depository institution has never been absolutely prohibited in the U.S. For most of the nation's history, commercial firms could own any type of banking institution, be it a commercial bank, a savings and loan association, or an industrial loan company. Indeed, as far back as 1799, New York State allowed Aaron Burr to use the surplus capital in a water company he owned to establish a bank (which ultimately became JPMorgan Chase). And as mentioned previously, during the Great Depression, General Motors and Ford organized new banks (the National Bank of Detroit and Manufacturers National Bank of Detroit) to help restart banking in Michigan.

Restrictions

The BHCA of 1956 was the first federal law restricting ownership of a bank. It prohibited any entity directly or indirectly engaged in any activity other than banking (and closely related products and services) from owning more than one bank. According to the FDIC (1987):

> *"[T]he primary purpose underlying [BHCA]'s passage was fear of monopolistic control in the banking industry. Federal regulators and independent bankers lobbied Congress for over twenty years to pass more restrictive bank holding company legislation, but it wasn't until the Transamerica case was lost by the Federal Reserve Board that legislation was approved. ... [In that case,] Transamerica controlled 46 banks, in addition to owning a large percentage of Bank of America. The Federal Reserve Board charged that Transamerica was in violation of the Clayton Antitrust Act by monopolizing commercial banking in the states of California, Oregon, Nevada, Washington and Arizona. In 1952, the Board ordered Transamerica to divest itself of all its bank stock, except for Bank of America, within two years."*

As a result of the 1956 law, the number of one-bank holding companies increased dramatically, until the BHCA was amended in 1970 to bar non-banking companies from owning even one bank. Any company, including a commercial firm, could still own one savings and loan institution, but the Savings and Loan Holding Company Act of 1967 prohibited commercial ownership of multiple savings and loans through the establishment of multi-thrift holding companies.

The fact that the BHCA defined a bank as an entity that offered both demand deposits and made commercial loans created an opening: It enabled a company engaged in diverse activities to organize or acquire a bank that did not offer *one* of these services. This indeed happened, giving rise to the federally insured depository institutions known as "nonbank banks." In response, Congress passed the Competitive Equality Banking Act (CEBA) in 1987, which grandfathered existing nonbank banks but suspended the formation of new ones while a study was conducted (and said study never happened). The Gramm-Leach-Bliley Act of 1999 eliminated the restrictions imposed on insurance companies and/or securities firms regarding bank ownership but prohibited commercial firms from owning unitary thrift holding companies in the future (ownership of existing unitary thrift holding companies was grandfathered). Gramm-Leach-Bliley also retained the exemption for parents of ILCs in the BHCA. By 1999, Congress repealed all restraints on ownership of banks by purely financial companies and explicitly left one point of entry into banking by companies that also engage in commercial activities: the acquisition or formation of an industrial loan company.

These ownership restrictions place the United States out of step with most countries around the world. According to World Bank data, only four of 142 countries surveyed prohibit the ownership of banks by commercial firms. Most importantly, this restricts the ability of the U.S. banking industry to draw upon the substantial equity of commercial firms. This, in turn, limits the ability of the U.S. banking industry to enlarge its capital base and thereby to maintain its role as a major player in the increasingly competitive global banking industry.

Understanding How ILCs Are Regulated

Those who have cautioned against allowing commercial firms to own ILCs, or banks more generally, have raised questions about oversight and the potential for parent companies to use their ILCs for anti-competitive practices. However, regulation that is already in place appears to be adequate to address these concerns.

For example, some observers fear that ILCs may endanger community banks if their commercial parents have the size, resources, and will to use predatory pricing to drive local bank competitors out of business. Others have expressed concerns that ILCs may have incentives to deny credit to their parents' competitors or their competitors' customers, to provide funds on preferential terms to their commercial parents, and to tie loans inappropriately to purchases of the parents' products. But unfair competition and conflicts of interest are prohibited under existing federal law, giving regulators the authority and the tools to address these issues without eliminating an entire industry.

While the sheer size of some of the corporations that might wish to enter this market has been a flashpoint in the debate, the Dodd-Frank Act also provides a means to limit the growth of any company that might pose a systemic risk to the economy. And in times of crisis, commercial firms do not gain direct access to the federal safety net (meaning FDIC insurance and access to the Federal Reserve discount window) merely by owning an ILC.

Is systemic risk heightened by the fact that ILCs and their parents are regulated by the states and the FDIC, rather than the Federal Reserve? Recent history would seem to indicate that is not the case; there is no evidence that the Federal Reserve has done or will do a better job than state regulators or the FDIC. (Indeed, in the most recent financial crisis, the Fed did not do a particularly good job of overseeing bank holding companies, while none of the state- and FDIC-regulated commercially owned ILCs failed.)

It is also important to consider the potential impact of a parent company failure. If this occurs and the ILC subsidiary is largely in the business of financing purchases from the parent, would the ILC be forced into insolvency? The record shows this has not been a problem in the past. ILCs, as separately chartered and capitalized subsidiaries, can continue to operate. In a worst-case scenario, an ILC with a failing parent would undergo a controlled liquidation with the goals of paying depositors (no losses to the FDIC), paying all other creditors in full, and paying a liquidating dividend to the parent. For instance, when Conseco filed for bankruptcy, its ILC subsidiary self-liquidated, paid all depositors and other debts, and then paid a large dividend to the bankruptcy trustee to pay the parent's creditors. The ILC owned by Lehman Brothers also remained solvent and is self-liquidating despite the bankruptcy of its parent. (According to the latest quarterly reports, in the past two years, it has shrunk from over $6.4 billion in assets to $2.8 billion, has a 26.6 percent capital ratio, and is earning about 2.4 percent ROA in the third quarter of 2010.) In two other instances, ILCs owned by companies that were reorganizing under bankruptcy laws continued operating normally under close regulatory oversight to ensure that the bank's assets were not used to help rescue the parent. More generally, these examples show that prudent regulation and supervision can prevent (and has prevented) any exploitation of the insured subsidiary by the parent when the parent faces financial difficulties.

Given the range of concerns that have been expressed about this little-known corner of the banking industry, it is essential to understand exactly how ILCs are regulated. ILCs are subject to all of the same restrictions and requirements, regulatory oversight, compliance, and safety and soundness exams as any other kind of bank. In addition, ILCs have more restrictions on the types of deposits they are able to offer compared to commercial banks. Unlike commercial banks, ILCs are required to have a majority of outside independent directors on their boards. Since all ILCs are state-chartered institutions, they are regulated and supervised like state-chartered commercial banks—and this includes being examined, supervised, and regulated by the FDIC. The most important distinction between ILCs and commercial banks is that ILCs may be owned by companies that engage in broader activities than banking or purely financial services.

ILCs and all of their affiliates must comply with the restrictions and prohibitions on affiliate transactions outlined in sections 23A and 23B of the Federal Reserve Act, which forbid a parent or affiliate from using an ILC as a source of financing. Furthermore, the "attribution rule" prevents an ILC from making any loan to any borrower if the loan proceeds are used for the benefit of an affiliate. Any transactions that are allowed between an ILC and affiliate must be on market terms. ILCs do not finance the sale of goods by an affiliate unless the loan is collateralized dollar-for-dollar with a cash deposit in the bank or a pledge of U.S. government securities. ILCs can only be organized and operated for other purposes in which conflicts of interest cannot arise. According to the U.S. Treasury Department in March 2008, "the history of commercial firms affiliating with insured depository institutions has not supported the view of greater risks present in such structures."

Consistent with these affiliate transaction restrictions, three general or broad types of ILCs have evolved over the past 20 years. One is a bank that is essentially a depository institution, with its own marketing program and assets kept separate and distinct from any parent. These are largely indistinguishable from traditional banks, but may just happen to be owned by a company that engages in other activities. Another is a bank that engages in a business that complements the business of its affiliates. (A good example of this type is Transportation Alliance Bank, which was organized to serve the normal banking needs of long-haul truckers who otherwise have little, if any, access to banking services while on the road.) These types of banks typically share common customers with their affiliates. Finally, there are banks that engage in covered transactions, financing sales by an affiliate. In accordance with section 23A, however, all such extensions of credit are secured dollar-for-dollar with cash deposits in the bank or a pledge of U.S. government securities. The institutions engaging in covered transactions represent the smallest group of banks—and ironically, they're perhaps the safest banks in the nation due to the collateral securing of their loans.

The Commercially Owned ILC Business Model

Data show that ILC parents can and do serve as a source of strength for their subsidiary ILCs, often to a much greater degree than bank holding companies. During the past several years, the FDIC has formalized that support through capital maintenance and liquidity support agreements with companies that own ILCs, and those companies are now subject to serving as sources of strength under the Dodd-Frank Act.

Moreover, most ILC parents serve as an important source of *governance* over their ILCs, since they do not want to incur any reputational damage to the parent's brand. Understandably, firms like BMW, Target, and Toyota consider their brands to be extremely important assets and go to great lengths to ensure that no part of the corporate group creates any negative or harmful publicity. The business model associated with commercial ILCs has multiple characteristics that contribute to their stability:

- *Marketing advantages and economies of scale.* Many ILCs serve the lowest-risk parts of a broader financial operation. The bank obtains its business with little or no marketing cost and often only makes loans selected from a broad pool of applicants. Even if the broader pool is affected in an economic downturn, it may have little impact on the loans made by the bank.
- *Geographical risk reduction.* Most ILCs serve specialized customer groups spread across the nation, which helps reduce risk through geographical diversification. Access to such a broadly diversified market is impossible for a bank not owned by a large diversified parent.
- *Capital.* In times of stress, a diversified parent may be in a better position to provide capital support to a bank subsidiary than a banking holding company whose assets consist almost entirely of a bank subsidiary.
- *Informational efficiencies.* An ILC parent engaged in multiple business lines may be better able to identify underserved markets and opportunities to provide banking services to customers of the parent. This information may enable the institution to make better loan decisions than traditional banks, to provide other financial services that are desired by the customers of the parent firm, and to make credit available when it is not readily available elsewhere. For example, the ILC owned by Harley-Davidson is in a much better position to assess the collateral value of a motorcycle than a typical bank. Transportation Alliance Bank, because of its affiliation with the company operating truck stops nationwide, is better positioned to serve the banking needs of long-haul truckers.

These underlying strengths were reflected in ILCs' performance as a group from 2007 to 2009, during the depths of the financial crisis and recession. Clearly, ILCs were not responsible for either of these events. For most of the past decade, both financially and commercially owned ILCs have been better capitalized and have performed better in terms of ROA as compared to all FDIC-insured institutions. In the second quarter of 2010, 82 percent of ILCs performed better than the average of all FDIC-insured institutions and 85 percent performed better than the average of all state-chartered institutions in terms of ROA. Furthermore, as of mid-2010, ILCs accounted for less than 2 percent of all FDIC-insured deposits, so they do not pose a serious threat to the Federal Deposit Insurance Fund at the present time or in the foreseeable future.

Conclusion

Previous academic studies that have examined the issue of mixing banking and commerce have found no evidence that allowing ownership of ILCs by commercial firms is unsound policy or that whatever risks might exist cannot be contained by appropriate regulation. In addition, according to the FDIC (1987), "the public policy implication of [this study's major] conclusion is that ... the Bank Holding Company Act ... should be abolished."

In summary, ILCs have performed well over the years—better, in many respects, than most other FDIC-insured institutions. There is simply no evidence that the U.S. financial system and the nation's economy would be on sounder footing if diversified firms were prohibited from owning ILCs, and this kind of empirical evidence should be required before acting on calls for any change in the ILC industry (especially its abolition through repeal of the current exemption for ILC owners in the BHCA).

Companies with diversified businesses may have significant expertise, resources, capital, and often an established credit business to contribute to a bank, both during the start-up phase and over time. As the U.S. Treasury Department (1991) pointed out, "the development of these broadly diversified firms has often proven beneficial to the economy at large, and financial markets in particular. Most important has been the ability and willingness of such firms to strengthen the capital positions of their financial services subsidiaries. ... The stability brought to the financial markets in this way is a net benefit to the economy overall."

During the most recent financial crisis, ILCs provided credit when other financial institutions were unable or unwilling to do so (due to a lack of liquidity or capital). If the ILC industry is allowed to grow, it may be able to tap into new sources of capital from companies that are otherwise prohibited from owning a bank by the BHCA. The total net worth of U.S. non-financial corporate businesses was $13 trillion as of mid-2010. If even a small percentage of this capital were invested in ILCs, it could contribute to an expansion in the availability of credit, a development that could have wider ramifications for U.S. economic growth.