Industrial Loan Companies Come Out of the SHADOWS

BY MICHELLE CLARK NEELY

A little-known segment of the U.S. financial services industry has been making big waves lately. Industrial loan companies (ILCs), also called industrial banks, have been around for almost 100 years, but only in the past couple of years have they been in the spotlight.

Most ILC owners are financial services firms, including some of the nation's leading companies: Merrill Lynch, American Express, Morgan Stanley and Goldman Sachs. The ILCs owned by these financial giants are among the industry's largest ILCs—averaging $30.5 billion in assets at year-end 2006—and enjoy considerable access to capital markets. Other ILCs that are owned by financial services firms are much smaller. Many ILCs—those owned by financial services firms and those owned by others—are narrowly focused on a single community, product line or customer type. For example, Wright Express Financial Services, a Utah ILC owned by Wright Express Corp., offers payment processing and information management services to the U.S. commercial and government vehicle fleet industry.

About one-quarter of ILCs are owned by nonfinancial companies. If commercial companies such as these want to own a financial institution, their only option is to obtain an ILC charter. These ILCs offer financial services that tend to directly support the products of their parent companies. Captive finance companies would fall into this category.

In the auto industry, General Motors, BMW, Volkswagen and Toyota all own ILCs, as does motorcycle manufacturer Harley-Davidson. General Electric, Pitney-Bowes, UnitedHealth Group and Target are other nonfinancial firms that control ILCs. More recently, The Home Depot—the world's largest home improvement specialty retailer—and Wal-Mart—the world's largest general retailer—have sought ILC charters.

Some of the recent attention and scrutiny can be traced to the industry's tremendous growth. Over the past two decades, the collective assets of these institutions have increased by more than 5,000 percent, and several ILCs rank among the nation's largest financial institutions. ILCs, formerly niche players in the financial marketplace, are an increasingly diverse lot, and many differ very little from commercial banks in terms of the products and services they offer.

But the reason ILCs are drawing so much attention now has less to do with their size and scope and more to do with who owns them—or wants to. The recent ILC applications by Home Depot and Wal-Mart have renewed long-standing national debates about the mixing of banking and commerce, the concentration of economic power and the proper role for federal banking supervisors.

Simple Beginnings

The first industrial loan companies appeared in the early 1900s. They were small, state-chartered institutions that made uncollateralized loans to low- and moderate-income workers who couldn't get such loans from banks. Because state laws at the time generally did not permit ILCs to accept deposits, they funded themselves by issuing to investors certificates of investment or indebtedness, dubbed thrift certificates.

Over time, the Federal Deposit Insurance Corp. (FDIC) granted deposit insurance to ILCs on an individual basis. All ILCs became eligible for deposit insurance with the passage of the Garn-St. Germain Depository Institutions Act of 1982. Some states then began requiring ILCs to be FDIC-insured as a condition for keeping their charters. As a result, most ILCs became subject to federal safety and soundness supervision by the FDIC—a condition for deposit insurance—as well as the supervision mandated by their chartering states.

Five years later, Congress passed the Competitive Equality Banking Act (CEBA). This 1987 legislation was designed to close perceived loopholes in federal banking legislation—holes that permitted commercial firms to own so-called nonbank banks.[1] Among other provisions, CEBA broadened the definition of a bank under the Bank Holding Company Act (BHCA) to include any institution that was insured by the FDIC, which would seem to include most, if not all, ILCs. But ILCs—relatively small in number and size at the time—were essentially left alone in the legislation. Several states were permitted to grandfather existing ILCs and continue to charter new ILCs, whose owners—financial or commercial—would not be subject to the BHCA and the consolidated federal supervision that goes with it.[2] (Consolidated federal supervision refers to a federal agency's ability to assess the financial and managerial strength and risks within the consolidated organization as a whole, including the parent company and nonbank affiliates.)

Banking Behemoths?

Since 1987, there has been tremendous change in the ILC industry. (See charts.) Some ILCs now rank among the largest financial institutions in the country. Utah-based Merrill Lynch Bank USA, the nation's largest ILC, had more than $67 billion in assets at year-end 2006, putting it in the top 20 among all U.S. financial institutions. In total, 17 ILCs, or 28 percent of the industry, had more than $1 billion in assets at year-end 2006, compared with about 7 percent of commercial banks.

Because of the grandfathering provisions of CEBA, the ILC industry is concentrated in a handful of states. Utah is home to just over half of currently operating ILCs, with 32, followed by California (14), Nevada (five) and Colorado (four). Eight of the 10 largest ILCs are Utah-based, and the state's ILCs account for almost 90 percent of the industry's assets. The Government Accountability Office (GAO) reports that officials from the Utah Department of Financial Institutions credit Utah's "business friendly" environment, among other reasons, for the dominance and growth of the ILC industry in Utah.[3]

In addition to getting bigger, ILCs are broadening their scope. While a number of ILCs are still niche players that provide specialized products for corporate parents or narrow segments of customers, others offer a wide variety of loan and investment products and are virtually indistinguishable from commercial banks. Two important features of ILCs—permitted commercial ownership and a lack of consolidated federal supervision—set them apart from commercial banks, however, and it's those traits that have put the ILC industry in the limelight.

Obscure No More

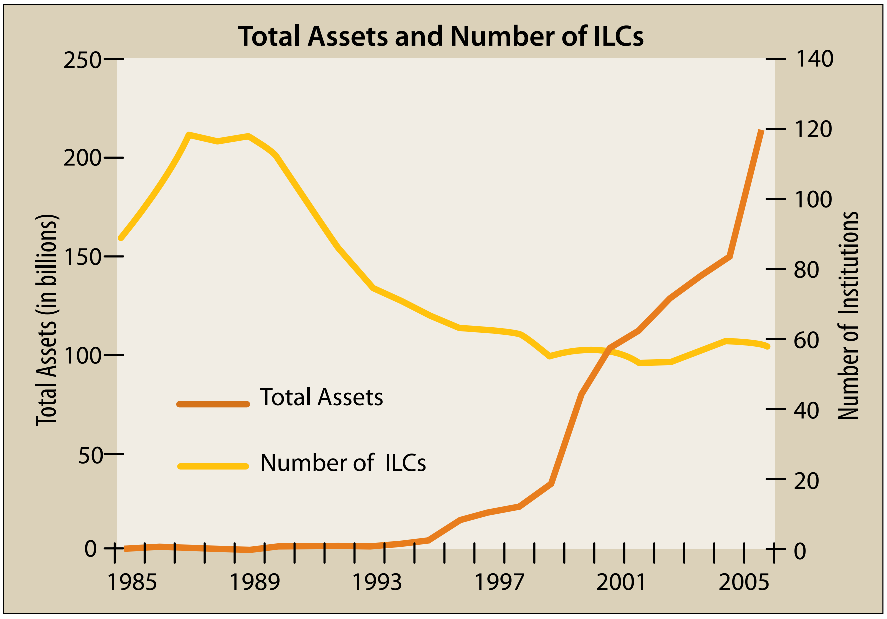
Much of the current debate about the ILC industry can be attributed to the banking ambitions of two of the nation's largest retailers—Home Depot and Wal-Mart. Home Depot is seeking approval to buy Utah-based EnerBank, an ILC currently owned by CMS Energy Corp. EnerBank makes loans to consumers to finance home improvement projects, and Home Depot says it intends to keep the ILC's business plan and corporate structure intact. In its May 2006 Change in Control Application to the FDIC, Home Depot notes that "EnerBank has had significant success helping local, small contractors achieve business success. This fits with The Home Depot's desire to expand its relationships with contractors and trade professionals—especially the local, small contractors that are core to The Home Depot's business."

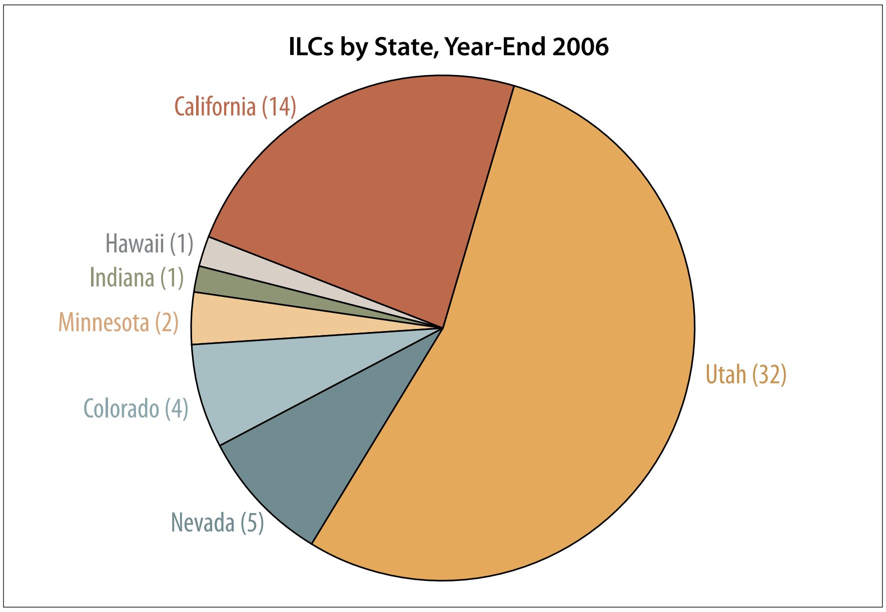
Wal-Mart, on the other hand, applied in 2005 to open a new ILC. It would be called Wal-Mart Bank and would also be based in Utah. In its application, the company stated that its ILC would not be engaged in retail banking—taking deposits from the public and making loans. Instead, Wal-Mart's ILC would be focused on processing electronic checks and debit and credit card payments, eliminating the need for a third-party processor; the savings would be passed on to Wal-Mart's customers through lower prices, the company said.

To say these applications were controversial is an understatement. Thousands of comment letters—the vast majority of them negative—were sent to the FDIC. The FDIC also held a series of public hearings about the Wal-Mart application in the spring of 2006. Members of Congress soon jumped into the fray. In June of last year, 98 members of Congress wrote a letter to the FDIC requesting a moratorium on approvals for new, commercially owned ILCs. And in early July 2006, Reps. Barney Frank, D-Mass., and Paul Gillmor, R-Ohio, introduced a bill that would permanently bar commercial ownership of ILCs retroactive to June 1, 2006.[4] The legislation would also require ILCs to be subject to federal consolidated supervision similar to that mandated for bank holding companies.

The FDIC responded at the end of July 2006, issuing a six-month moratorium on approving ILC applications. In August, the agency issued a Notice and Request for Comment, seeking public comment on 12 questions related to ILC ownership and supervision. When the comment period ended, the FDIC had received more than 10,000 letters, including ones from Home Depot, Wal-Mart and a number of existing ILCs.[5] State legislators in more than a dozen states began debating, and in many cases enacting, legislation that would, in effect, bar banks from opening branches on the grounds of a commercial affiliate.[6]

Because Frank and Gillmor's ILC legislation wasn't acted on last year, they reintroduced it in late January 2007. Two days later, the FDIC announced it was extending the freeze on approvals of ILC applications by nonfinancial firms for one year. Financial firms that wished to charter or buy ILCs could still submit deposit insurance applications. That left four nonfinancial firms, including the giant retailers, in limbo. Wal-Mart ended up pulling its deposit insurance application in March. Home Depot recently reworked its deal with CMS to buy EnerBank, giving the retailer more time to get its ILC application through the FDIC.





Supervisory Blind Spot?

Concern about the growing size of the ILC industry had been building for several years prior to the Home Depot and Wal-Mart bids. Bankers' organizations, consumer groups, some banking regulators—including then-Fed Chairman Alan Greenspan—and several members of Congress had protested the exploding growth of a "parallel banking system." Requests from the ILC industry that it be included in proposed legislation that would allow banks to offer business checking accounts and to branch nationwide raised more unease. Once Wal-Mart and, to a lesser extent, Home Depot threw their hats into the ring, the protests grew louder and the issue took on front-burner status.

Most of the criticism being leveled at the ILC industry centers on commercial ownership and can be boiled down to its effects on competition and safety and soundness. Critics typically offer one or more of the following objections to commercial ownership. First, letting nonfinancial firms own ILCs runs counter to a long-standing—though somewhat porous—barrier in the United States between banking and commerce. Second, letting large commercial companies like Home Depot and Wal-Mart into banking will create economic conglomerates and could concentrate economic resources into the hands of a few. Third, some ILCs, unlike most other regulated financial institutions, are not subject to consolidated supervision at the federal level, creating safety and soundness, as well as competitive, issues.

The debate about the mixing of banking and commerce in the United States is a long-standing one. Although numerous exceptions (including commercially owned ILCs) have occurred, federal and state laws have attempted for the most part to keep the two separate. Those opposed to joint ownership of banking and nonfinancial businesses say a combination would produce risks that far

Though the number of ILCs has declined by about half over the past 20 years, the industry's assets have grown exponentially. More than three-fourths of all ILCs are based in Utah and California.

outweigh any benefits. Those perceived risks include conflicts of interest, a lack of impartiality in credit decisions, the creation of monopoly power and an expansion of the federal safety net.

Conflicts of interest could arise in a number of ways. First, a commercially owned financial institution could grant loans to its affiliates at below-market terms, resulting in distortions in the credit-granting process. Tying, which occurs when the provision of one product or service is dependent on the purchase of another product or service, is also a frequently cited concern, even though it is generally illegal in the United States for all businesses. The use of inside information to benefit one affiliate of a firm at the expense of outsiders is another potential conflict of interest.

Opponents of commercially owned ILCs also express worries about a concentration of economic power in banking that could seriously impair competition. Public and political distrust of large companies, especially banks, is deeply ingrained in American history and accounts for much of the impetus for keeping banking and commerce separate. Indeed, one of the major fears expressed about a Wal-Mart bank is the notion that it could become a local banking monopoly, putting community banks out of business in some small markets.

Giving commercial firms access to the federal safety net—deposit insurance and the Federal Reserve's discount window and payments system—is yet another perceived risk, especially if these firms are not subject to the same supervision and regulations imposed on financial firms with federally insured depository institutions. Here, the concern is that the bank could make loans or engage in other activities that would benefit an affiliate or the parent, but that would threaten the solvency of the bank. And because ILCs—which operate only under very

Wal-Mart: Always Controversy. Always.

Wal-Mart's 2005 application to the Utah Department of Financial Institutions (for an ILC charter) and to the FDIC (for federal deposit insurance) marked the fourth time that the retail giant has attempted to enter the banking business.

In 1999, the company tried to acquire Federal BankCentre, a small savings and loan institution in Broken Arrow, Okla. But this first venture was thwarted when Congress passed the Gramm-Leach-Bliley Act (GLBA) of 1999, which prohibited commercial companies from acquiring unitary thrifts like Federal BankCentre after May 4, 1999. Wal-Mart missed that deadline and dropped its bid.

Two years later, Wal-Mart announced plans to offer banking services to its customers through a joint venture with TD Bank USA, a subsidiary of Canada's Toronto-Dominion Bank. The companies planned initially to offer banking services in 100 Wal-Mart stores; Wal-Mart retail employees were going to be permitted to perform banking transactions in those stores. But the arrangement was torpedoed by the Office of Thrift Supervision (OTS) after the agency determined that the plan violated regulations designed to keep banking and commerce separate.

Undeterred, Wal-Mart sought permission in 2002 to buy Franklin Bank, an ILC based in Orange, Calif. As with its most recent attempt to charter an ILC in Utah, Wal-Mart stated that it planned to use the acquired ILC to process the millions of debit card transactions made in Wal-Mart stores each month. Buying Franklin would have given Wal-Mart access to the electronic payments system, permitting it to drop its third-party processors. The bid drew the attention of community bankers and other opponents, who lobbied the state legislature to pass a law that would prohibit the purchase. In the last two weeks of the 2002 legislative session, California enacted a law barring commercial firms from buying or chartering ILCs.

When Wal-Mart submitted its Utah ILC charter application in July 2005, the company's assurances that it had no intention of engaging in retail banking did nothing to quell the opposition. In response to some of the criticism, the company reversed its request to be exempt from the Community Reinvestment Act (CRA); executives said earlier that the law would not apply to Wal-Mart's ILC because it would not be dealing directly with the public.

The outcry about Wal-Mart's latest application prompted the FDIC to hold public hearings on Wal-Mart's deposit insurance application—a first in the agency's 74-year history. The hearings, held over three days, featured more than 60 presenters and drew hundreds of people. The vast majority of witnesses urged the FDIC to deny Wal-Mart's deposit insurance application. Though most objections were based on competitive and safety and soundness concerns, others focused on the company's labor policies and more issues unrelated to banking. Even former Utah Sen. Jake Garn, who helped boost the ILC industry in his home state, testified that he had asked Wal-Mart executives not to apply in Utah because he was afraid that a Wal-Mart application would create trouble for the whole industry.

Subsequent congressional hearings and an FDIC request for public comments about the ILC industry produced more of the same. Although proponents of commercial ownership of ILCs testified and outlined compelling arguments in favor of the status quo, they were vastly outnumbered by opponents who argued against it. Many expressed concerns that Wal-Mart would change its business plan and expand its banking operations after its ILC charter was granted, despite the company's assurances.

The heat was turned up again in January 2007, when federal legislation to bar commercial ownership of ILCs was reintroduced in Congress and the FDIC extended its freeze on approving ILC applications by commercial owners. More state legislatures began passing bills that would prevent commercially owned ILCs from branching into their states, and observers credit (or blame) Wal-Mart for the flurry of activity.

In mid-March 2007, Wal-Mart withdrew its deposit insurance application, citing the "manufactured controversy" over its ILC charter bid. Company officials said it would work to expand financial services—like check cashing and bill paying—that did not require a bank. Executives also pledged to continue Wal-Mart's partnerships with retail banks located in many of its stores and indicated that making loans through these third-party partnerships was a possibility.

The ILC bid was not in vain, however; spokesmen indicated that Wal-Mart's payment services providers had lowered their prices, recognizing that the company was serious about cutting these costs.

limited constraints—are not subject to the BHCA, their corporate parents are not supervised to the extent those of other insured financial institutions are, thus potentially creating an uneven competitive playing field.[7]

Though very few critics of ILCs in their current form find fault with past supervision of ILCs, Federal Reserve officials and others, such as the GAO, maintain there are potential problems with a lack of supervisory authority over ILC parents. In testimony before the U.S. House Subcommittee on Financial Institutions, Scott Alvarez, general counsel for the Federal Reserve Board (FRB), noted:

The primary federal bank supervisor for an ILC [the FDIC] may take enforcement action against the parent company or a nonbank affiliate of an ILC to address an unsafe or unsound practice only if the practice occurs in the conduct of the ILC's business. Thus, unsafe and unsound practices that weaken the parent firm of an ILC, such as significant reductions in its capital, increases in its debt or its conduct of risky nonbanking activities, are generally beyond the scope of the enforcement authority of the ILC's primary federal bank supervisor.

To solve such potential problems, some policymakers and ILC industry critics propose that the FDIC be given consolidated supervisory powers over ILC parents equivalent to the Federal Reserve's authority over bank holding companies and to the Office of Thrift Supervision's (OTS) authority over thrift holding companies; others believe such powers over ILCs should go to the Federal Reserve. The FDIC itself has asked for additional supervisory authority over ILC parents and has imposed new restrictions and conditions on recently granted deposit insurance applications by ILCs with financial parents.[8]

Proponents' Response

The ILC industry in its current form has a number of backers. Many economists argue that the wall between banking and commerce is not only artificial but unnecessary and may do more harm than good if resources are allocated inefficiently. There may be operational efficiencies—economies of scale and scope, as well as informational efficiencies—from combining commercial and financial firms that would reduce the costs of providing goods and services. Such combinations may produce greater product and geographic diversification for firms, lessening the chance of failure, as well as greater access to capital for firms of all types and sizes. Put succinctly, allowing new entrants in the financial services industry will likely increase competition, reduce costs and increase choices for consumers, proponents say.

In terms of safety and soundness, all ILCs are supervised by their chartering states, as well as by the FDIC; some ILCs are also subject to consolidated federal supervision by the OTS. The so-called bank-centric or bank-up approach to ILC supervision has its supporters. In this model, a bank's supervisor has examination and regulatory authority over the bank only and may have limited ability to examine and take supervisory actions against the bank's holding company or affiliates. Proponents argue that the current regulatory framework for supervising ILCs is more than sufficient to protect the deposit insurance fund and, hence, the taxpayers from losses. Though about two dozen ILCs have failed in the past 20 years, just two of the failures resulted in material losses to the deposit insurance fund.[9]

ILC industry backers point to the bankruptcy of Conseco Inc. in 2002 as an example of how the bank-up approach can and does work. Conseco's profitable Utah-chartered ILC, Conseco Bank, was sold at book value to GE Capital when the parent declared bankruptcy, with no loss to the FDIC.[10] Similarly, when Tyco International, a maker of electronics, plastics and fire and security products, went into financial distress and was embroiled in corporate scandals in 2002, it successfully spun off its Utah industrial bank, which still operates today as CIT Bank.

What's Next?

Wal-Mart's decision to withdraw its ILC application has taken some of the heat out of the firestorm over ILCs. Nevertheless, given the current climate, it appears likely that the ILC industry will be subject to more regulation, both at the ILC and parent company levels. The Frank-Gillmor bill, recently passed by the full House, would require federal consolidated supervisory authority over the industry and divide it among the OTS, FDIC, Federal Reserve and the Securities and Exchange Commission.

A Senate version of the House ILC bill was introduced by three senators in mid-May. Observers expect the bill to have a rougher going there, primarily because Utah Sen. Bob Bennett, the No. 2 Republican on the banking panel, staunchly opposes curbs on the ILC industry. Bill backers in both chambers have floated the idea of an exemption for automakers on a ban on commercial ownership, which may placate some lawmakers hesitant to pass the existing bill.

Michelle Clark Neely is a visiting scholar at the Federal Reserve Bank of St. Louis. Yadav Gopalan provided research assistance.

ENDNOTES

1 A nonbank bank is a financial institution that either accepts demand deposits or makes commercial loans. Since the BHCA prior to CEBA defined a bank as an institution that does both, the holding companies of nonbank banks were able to avoid supervision by the Federal Reserve.

2 Grandfathered states include California, Colorado, Hawaii, Minnesota, Nevada and Utah. See GAO (2005) for more detail on CEBA and how it affected the ILC industry.

3 See GAO, pp. 18-21, for more information on the evolution of the ILC industry.

4 A commercial owner is defined as a company that derives more than 15 percent of its revenue from nonfinancial activity.

5 A large proportion of the letters were form letters. For example, more than 7,000 letters were from members of a group called "Close Loophole Advocates." Employees of Home Depot sent in almost 1,700 duplicate letters.

6 See Adler (March 13, 2007) for more detail on state efforts to curtail commercial ILCs.

7 To be exempt from the BHCA, ILCs cannot offer demand deposits that the depositor may withdraw by check or other means to make payment to third parties. Small ILCs (less than $100 million) and ILCs chartered before Aug. 10, 1987, are not subject to any restrictions to be exempt from the BHCA.

8 See Adler (April 23, 2007) for examples of new requirements and curbs imposed by the FDIC on recent ILC applications.

9 See GAO (2005), pp. 59-61.

10 See Blair (2005).

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