Industrial Loan Companies Redux

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The move toward banking industry "disruption" and new "fintech" opportunities has resulted in a revisiting of the industrial loan company (ILC) charter- once a feared vehicle for expansion by Wal-Mart and others into the banking industry.

In 2010, Dodd-Frank imposed a moratorium on new ILC charters. That moratorium expired in July of 2013. News that online lender SoFi submitted an application to the FDIC for an ILC charter in June of this year, coupled with news that credit card technology facilitator Square is likely to undertake the same process, has renewed interest in the ILC charter as a method of revitalizing the old "non-bank bank" concept for fintech purposes. The banking industry is watching with great interest, and the ICBA has filed a request for a two-year moratorium on new ILC charters.

The precedential value of a fintech company using the ILC charter to access the banking system could be very significant.

Since the ILC charter concept has been somewhat dormant since the enactment of Dodd-Frank, it is important to revisit what in fact ILCs are and what they can and cannot do.

The following is an overview of the ILC charter and a historic perspective on what generated the last industry turmoil with respect to ILCs and their impact on banking.

Historical Perspective

ILCs were an outgrowth of the former "Morris Plan" institutions that focused primarily on consumer loans for working people and auto financing. They evolved over the years into what are now ILCs- which represent a hybrid "non-bank bank" that can be owned by commercial and industrial companies, offering FDIC-insured deposits but with limited nationwide banking powers. The lending and low-cost insured deposit funding benefits to commercial and industrial companies in

financing their products for consumers through an entity that does not make the parent company a “bank holding company” are obvious. ILCs can, and do, make all kinds of loans, not just consumer loans.

The pre Dodd-Frank (and pre “great recession”) application of Wal-Mart to charter an ILC, the proposed acquisition by Home Depot of a Utah ILC, and the media coverage of the industry firestorm surrounding those proposals earlier this century, resulted in a focus on the once-quiet world of the ILC and its role in the banking and financial services arena. The fact of the matter is that ILCs have been operating quietly in the background for years and have grown, according to government statistics, from approximately $3 billion in assets to over $102 billion in assets from 1987 to 2011. Several individual ILCs hold billions of dollars in assets and deposits. In past years, the Wal-Mart and related proposals generated significant industry and consumer advocate interest and commentary. They were, at the time, the genesis for an extensive GAO study and report on ILCs and their impact on the financial services industry (GAO-05-621, September 15, 2005; “*Industrial Loan Corporations-Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*”). The GAO report was in response to a request by Congressman Jim Leach in consideration of the Wal-Mart application, and has brought a new focus and prominence to the ILC issue as a whole.

So just what are ILCs, how are they different from banks and thrifts, and what is their future in the financial services market?

Background

The mix of banking and commerce in the U.S. has been severely restricted for decades. ILCs represent one of the few remaining “loopholes” to entering the banking business without being classified as a “bank” for Bank Holding Company Act (BHCA) purposes. In other words, large industrial and commercial companies can (and do) own and operate ILCs without being classified as a “bank holding company” under the BHCA, thereby avoiding Federal Reserve supervision and regulation and the restrictions on commercial activities that being a bank holding company bring.

ILCs are cut from the same basic cloth as other “non-bank banks” which resulted primarily from certain specific exceptions to the definition of “bank” contained in the Competitive Equality Banking Act of 1987. Those exceptions spawned a variety of “limited purpose” institutions, including “credit card banks” and pure trust companies. ILCs also successfully escaped the banking and commerce “loophole” closings contained in the Gramm-Leach-Bliley Act in 1999, and continue to represent one of the few remaining exceptions to the general prohibition on combining commerce and banking.

A moratorium on new ILC charters was imposed by Section 603 of Dodd-Frank in 2010, and the moratorium expired in July of 2013. Up to now, the ILC world has been relatively quiet. However, with the new challenges presented by the fintech revolution, that is about to change.

How are ILCs Structured?

Despite the name, ILCs are basically state-chartered “banks” which secure FDIC insurance for deposits. Presently a number of states charter ILCs, the most prominent of which are Utah, Nevada and California. ILCs have branching rights similar to federal thrifts, subject to certain state law constraints.

What Products do ILCs Offer?

ILCs may engage in traditional banking activities and offer virtually all kinds of traditional bank products including commercial, mortgage, credit card, and consumer lending products; payment-related services (including fedwire and ACH); and FDIC-insured time and savings deposits (subject to the limitation that they may not offer checking accounts if the ILC is larger than $100 million in assets), all with no restriction on type or location of customer.

Who Owns and Operates ILCs Today?

It often comes as a surprise to learn that, according to government reports, such large and well-known multinational companies as General Electric, General Motors, Pitney-Bowes, Morgan Stanley, Merrill Lynch, UBS, Goldman Sachs, GMAC, Volkswagen, BMW, and Volvo own and operate ILCs (or have done so in the past). Some are owned by financial companies. Again, ILCs have grown quietly with little fanfare over the years, becoming significant potential competitors in the financial services market.

Can ILCs Branch?

Under current banking law, it is conceivable that Utah-chartered ILCs, for instance, through state branching reciprocity could branch into Ohio, Massachusetts, Illinois, Texas, and a variety of other states. However, branching rights may not be a concern or even an issue for the fintech industry.

Regulatory Oversight

ILCs are regulated by their chartering state and the FDIC. The Federal Reserve and Treasury are not involved in ILC chartering or oversight, and the views of the federal agencies appear to differ somewhat on the viability and impact of the ILC charter. A GAO report issued in 2012 did not recommend any changes in the supervisory oversight of ILCs. “Source of strength” requirements imposed by Dodd-Frank for entities that control ILCs, similar to the “source of strength” doctrine of the Federal Reserve, may pose additional obstacles for proposed acquirers and organizers of ILCs in providing sufficient comfort with respect to their ability to support the underlying ILC in times of financial need. Capital maintenance agreements may be required of acquirers or organizers in order to keep the ILC “well capitalized.” Whether and how the “Volcker Rule” from Dodd-Frank may be imposed remains to be seen.

What Does This Mean to Banks and Thrifts?

The primary issues of concern to banks are those of competitive equality and safety. While bank holding companies are subject to extensive Federal Reserve oversight and significant restrictions on the activities which may be engaged in by the holding company and affiliates, ILCs and their affiliates are not subject to the same restrictions although their financial products and services are similar if not identical in many respects. Some argue that the failure to implement the same restrictions and regulatory safeguards for ILCs make them inherently more risky to the insurance fund than other FDIC-insured institutions, and that costs resulting from ILC issues and failures will ultimately be borne by the banking industry. Other issues raised by opponents include the potential for excessive concentration of resources resulting from combining banking and commerce, the potential for expansion of the federal bank “safety net” to ILC affiliates, and potential unfair allocation of credit by ILCs to related organizations.

What Happens Now?

Multiple hearings were conducted by the FDIC as a result of unprecedented commentary on the Wal-Mart proposal by industry participants, trade associations, consumer advocates, and regulatory agencies. During this time period Wal-Mart committed to limit its activities to those specifically referenced in their application and to refrain from seeking expanded banking powers. The SoFi application may or may not have a similar result.

Following lengthy publicity on the pending Wal-Mart application at the time, the FDIC announced a six-month moratorium on ILC applications by commercial companies (which was subsequently extended to January 31, 2008), while applications by financial companies were allowed to go forward. The FDIC also announced its intention at the time to issue a proposed rule intended to "…strengthen the framework for consideration of applications or notices for industrial banks owned by financial companies not subject to federal consolidated bank supervision."

In announcing the moratorium and proposed rulemaking at the time, former FDIC Chairman Sheila Blair said: "The growth in commercial ownership of ILCs raises public policy concerns. The moratorium will provide Congress with an opportunity to address the issue legislatively while the FDIC considers how best to respond to any safety and soundness issues surrounding the commercial ownership under existing law."

Wal-Mart elected in mid-March 2007 to withdraw its 2005 ILC application from consideration by the FDIC.

The SoFi Application and "fintech" Implications Generally

Whether the SoFi application will generate the same publicity and angst remains to be seen. The potential for "disruptive" use of the ILC charter by fintech entities is significant.

While Congress may renew the debate as to whether ILCs are properly outside of the restrictions of the BHCA, states are still able to charter ILCs without restriction (subject to the FDIC process). The public policy and industry implications are also significant, and whether (and for how long) ILCs will continue to be able to operate outside of the BHCA, and Federal Reserve supervision, particularly as commercial company affiliates, also remains to be seen.