The Industrial Loan Company Controversy

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For the past several years, legislation to reduce regulatory burden in the financial services industry has been repeatedly bogged down by a controversy involving a little known type of financial intermediary – the "Industrial Loan Company" or "ILC." These institutions represent one of the few remaining methods by which a commercial company may own an insured depository institution, and efforts to exclude these companies from more general regulatory relief legislation has rekindled the debate over mixing banking and commerce. In part this arose from a proposal made by Wal-Mart in 2002 to charter a new ILC in California, and use this institution to provide financial services in its stores.[1] This article will review the history and current legal status of industrial loan companies.

Historical Background

Industrial loan companies or "industrial banks" were formed during the turn of the 20th Century as institutions that catered to the credit needs of low-wage industrial workers.[2] These early ILCs offered relatively high interest unsecured loans to factory workers who could not otherwise obtain credit. Instead of receiving deposits, these companies typically raised funds by issuing "certificates of investment" or "certificates of indebtedness. " However, Colorado and Rhode Island began to authorize ILCs to accept deposits, sometimes denoted "thrift certificates, " and the FDIC began to issue federal deposit insurance to institutions in these States as early as 1958.[3] However, most ILCs were not qualified to become federally insured until the Garn-St Germain Act of 1982[4] authorized FDIC insurance for ILCs meeting regulatory standards.

By the mid-1980s, companies engaging in non-financial activities sought to obtain control over one or more depository institutions. At that time, the Bank Holding Company Act ("BHC Act") strictly limited the permissible activities of bank holding companies, so that companies engaging in insurance, securities underwriting, or commercial business could not own or be affiliated with a bank. However, the BHC Act narrowly defined the term "bank" to mean an institution that both: (i) accepted demand deposits and (ii) made commercial loans. To get around the BHC Act prohibition, companies formed "non-bank banks" that did not engage in both activities. For example, instead of accepting demand deposits, some of these institutions offered NOW accounts. Other non-bank banks became consumer lenders and did not make

[1] This proposal was effectively terminated by legislation in California limiting the ability of Wal-Mart to acquire a California state chartered institution.

[2] FDIC, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective" (June 25, 2004).

[3] Id at 4. Between 1958 and 1979 at least six ILCs received FDIC insurance.

[4] Public Law 97-320 (1982).

commercial loans.

CEBA Legislation

In response to this development, the Federal Reserve Board sought legislation to change the definition of the term “bank” to include non-bank banks. In 1987, Congress enacted a new definition of “bank” in the Competitive Equality Banking Act (CEBA), so that any FDIC-insured institution became a “bank” covered under the BHC Act. However, many exceptions were written into that law, and existing non-bank banks were grandfathered.

With respect to ILCs, the legislation created an exception for four classes of ILCs from the new definition of a “bank.” These classes are:

1. An ILC that does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties;

2. An ILC that has less than $100 million in total assets;

3. An ILC that has not undergone a change in control after the date of enactment of CEBA (August 10, 1987), and

4. An ILC that does not, directly or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987.

With respect to classes 1 through 3, the ILC must be organized in a State that required FDIC insurance for its industrial loan companies as of March 5, 1987, or had such a proposal under consideration in the State legislature. There is no such requirement for class 4.

Any ILC that is protected by any of these provisions will lose that protection, and become a “bank” under the BHC Act, if it permits any overdraft (including an intraday overdraft) at the institution's account at a Federal Reserve Bank on behalf of an affiliate.[5]

It is important to recognize that these exceptions (other than class 4) do not require that the ILC be in existence as of a certain date. Thus, a new ILC can be chartered in an appropriate State at any time, and the BHC Act will not cover the institution so long as it meets one of the grounds listed above.

Post-CEBA Developments

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5 However, an overdraft that results from an inadvertent computer or accounting error that is beyond the control of the ILC and the affiliate is excused, as well as an overdraft on behalf of an affiliate in connection with activities that are financial in nature (and that does not violate sections 23A or 23B of the Federal Reserve Act). 12 U.S.C. § 1841(2)(H).

As noted previously, most ILCs are authorized to engage in traditional financial activities that are available to all charter types. They make all kinds of consumer and commercial loans and may accept federally insured deposits. They may be original issuers of Visa or MasterCard credit and debit cards and may fund their operations with Federal Home Loan Bank borrowings. An ILC may be organized as a limited-purpose or credit-card institution, and thus limit its products and services to those specified by its charter.

ILCs are subject to the same regulatory and supervisory oversight (including the laws and regulations pertaining to bank safety and soundness and consumer protection) as other State-chartered banks, except for the BHC Act and the Federal Reserve Board's supervisory authority over companies that own or control "banks." This exemption from the BHC Act is very troubling to the Federal Reserve Board. The Board's position is that "allowing a commercial or financial firm to operate an insured nationwide bank outside the supervisory framework established by Congress for the other owners of insured banks raises significant safety and soundness concerns, creates an unlevel competitive playing field, and undermines the policy of separating banking and commerce that Congress reaffirmed in the Gramm-Leach-Bliley Act of 1999."

On the other hand, the flexibility of the ILC charter and its exemption from holding company regulation has made this type of institution an attractive choice for companies that are not permitted to, or choose not to, become subject to the restrictions of the BHC Act. As a result, it is not surprising that the parent companies of ILCs include a diverse group of commercial firms.[6]

Legislative Proposals – the Gilmore-Frank Amendment

The ILC exemption from the definition of a "bank" under the BHC Act has been raised recently in connection with regulatory reform proposals, as well as with legislation to permit the payment of interest on checking accounts and Federal Reserve required reserves. Last year, H.R. 1375, as passed by the House of Representatives contained language known as the "Gilmore-Frank" amendment.[7] This provision was also included in the legislation recently passed by the House of Representatives to permit commercial banks to pay interest on checking accounts.[8]

Under the Gilmore-Frank provision, the benefits of the legislation will not apply to any ILC that is owned by a parent company that receives 15 percent or more of its annual gross revenues from non-financial activities. However, this restriction will not apply to:

(I) An ILC that became insured before October 1, 2003 or pursuant to an

6 C. Blair, "The Future of Banking in America: The Mixing of Banking and Commerce," FDIC Banking Review (2004).

7 Section 401(b)(2) of H.R. 1375.

8 H.R. 1224, passed by the House on May 24, 2005.

application for insurance what was approved by the FDIC before that date; and

(II) There was no change in control of the ILC after September 30, 2003.

Conclusion

Industrial loan companies remain as one of the few types of FDIC-insured depository institutions that are not subject to the BHC Act. As such, they are attractive vehicles for non-financial companies seeking to own or control a bank. However, ILCs must conform to certain restrictions in order to retain their exemption from the BHC Act. In addition, recent activity indicates that the Federal Reserve Board has strong views that these institutions should be limited, and some in Congress have taken the position that ILCs should not get the legislative benefits that would be provided to depository institutions under recent legislative proposals.

Ray Natter would be pleased to answer any additional questions you may have regarding industrial loan companies. He may be reached at rnatter@barnett-sivon.com.