Background on the Separation of Banking and Commerce and the Current Debate Over ILCs

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Steve and Lisa have asked that I provide some background on the separation of banking and commerce in the U.S., and that I address the current debate surrounding industrial loan companies.

I'll start with the separation of banking and commerce. First, I should note that – in this context – commerce means not only commercial activities, such as manufacturing, but also securities and insurance activities.

The separation of banking and commerce has been a long-standing goal for many policymakers and industry groups. Yet, it is a goal that has never been fully realized.

When you look at the history of banking and commerce in the U.S. in the 20^{th} century, you will find a recurring pattern in which market forces propel combinations of banking and commercial firms, and policymakers respond by passing laws to limit or prohibit such combinations. Often, but not always, these laws grandfather existing combinations. The net result has been the emergence of a system in which various charters and corporate structures are used to engage in various types of financial and commercial activities.

A review of the major banking laws adopted in the past century illustrates this pattern of the market pressures and policy responses.

In the early 1930's, the debate over banking and commerce centered around affiliations between commercial banks and securities firms. The policy response to those affiliations was the passage of the Glass-Steagall Act, which mandated the separation of most – but not all – banking and securities activities. Even after the passage of that Act, commercial banks were able to underwrite certain types of securities.

In the 1950's, the debate over banking and commerce arose in response to the growth of diversified bank holding companies. The Transamerica Corporation was symbolic of this trend. Transamerica owned a bank, an insurance company, real estate and oil development firms, and a fish packing company.

The policy response to Transamerica and other diversified firms was the passage of the Bank Holding Company Act of 1956 and the 1970 Amendments to that Act. Those laws limited bank holding companies to activities closely related to banking, and required the divestiture of non-conforming businesses.

On the other hand, those laws permit bank holding companies to own up to 5 percent of the shares of any company. Also, those laws did not apply to the ownership of thrifts. As a result, Lehman Brothers established the Great Western Financial Corporation, and subsequently, a number of commercial and retail firms, including Ford and Sears, acquired savings and loans and became unitary savings and loan holding companies.

In the 1980's, the debate over banking and commerce revolved around the creation of non-bank banks. At that time, a number of commercial firms established FDIC-insured banks that either made commercial loans or accepted demand deposits, but did not do both. This permitted the commercial firms to operate outside of the activity restrictions of the Bank Holding Company Act, and outside Fed supervision.

Congress closed the so-called non-bank bank loophole with the passage of the Competitive Equality Banking Act of 1987 ("CEBA"). Non-bank banks in existence at that time were grandfathered, subject to certain growth and acquisition limitations.

CEBA also created an exception for industrial loan companies, which I will return to in a moment.

The 1990's saw the re-emergence of affiliations between commercial banks and securities firms through so-called Section 20 subsidiaries of bank holding companies. These companies were principally engaged in underwriting government securities, but could underwrite a limited amount of corporate securities. The growth of Section 20 subsidiaries was central to the passage of the Gramm-Leach-Bliley Act. That Act repealed the restrictions on affiliations between banks and securities firms established in the Glass-Steagall Act.

Gramm-Leach-Bliley did two other things of note. First, it permitted holding companies to engage in any other type of financial activity, including insurance underwriting, as long as the holding company was subject to consolidated supervision by the Fed. Second, it closed the so-called unitary thrift loophole, and prohibited the ownership of thrifts by commercial firms. Existing commercial affiliations were grandfathered.

In summary, over the past century, we have seen market forces lead to various types of combinations between banking and commercial firms, and we have seen policy responses to those developments. The result is a system in which affiliations between banks, securities firms and insurance companies have become accepted – subject to Fed oversight – and in which many affiliations between banks and thrifts and commercial firms have been allowed to continue – outside of Fed oversight.

That brings me to ILCs. Today, the debate over the separation of banking and commerce is focused on industrial loan companies or ILCs. ILCs are state-chartered, FDIC-insured institutions that may engage in lending and deposit taking activities.

When Congress closed the non-bank bank loophole in 1987, it carved out an exception for ILCs. That exception permits a commercial company to own an ILC as long as (1) the ILC is chartered in one of the few states that chartered such institutions in 1987; (2) the ILC is FDIC-insured; and (3) the ILC does not accept demand deposits if it has assets over $100 million.

This exception does not stop an ILC that has assets over a $100 million from accepting NOW accounts. Therefore, an ILC owned by a commercial firm can engage in most basic banking activities.

Until 1997, there were only about 30 FDIC-insured ILCs in operation. In that year, Utah lifted a moratorium on the chartering of ILCs and expanded the powers of its ILCs. Since then the number of ILCs has doubled, and currently, three companies, Wal-Mart, Sallie Mae, and Daimler-Chrysler, have applications pending for deposit insurance on ILCs.

The Wal-Mart application has generated a fair amount of concern. While the application states that Wal-Mart plans to use its ILC for electronic payment processing, critics are concerned that Wal-Mart could use the institution to set up branches in its stores. The comment period on that application has been extended until September 23rd.

ILCs also have become an issue in the context of Congressional proposals to permit FDIC-insured banks to pay interest on corporate checking accounts and to engage in interstate branching on a de novo basis. In that context, some members of Congress have proposed that ILCs owned by commercial firms not be permitted to engage in these new activities unless the ILC had received FDIC insurance before October 1, 2003 (or had an application pending for insurance as of that date). For purposes of this grandfather, a commercial firm is defined as a company that derives more than 15 percent of its revenues from non-financial activities. Therefore, this limitation would not affect most securities and insurance firms.

The growth of ILCs and the potential for them to gain additional powers has been a source of concern for the Federal Reserve Board. Members of the Board have repeatedly told Congress that the growth of ILCs undermines the separation of banking and commerce, and permits these institutions to operate outside of the scope of consolidated supervision and regulation applicable to financial holding companies.

In rebuttal, the FDIC has told Congress that ILCs are subject to the same capital, anti-tying, insider lending, consumer protection, CRA and affiliate transaction provisions applicable to any other FDIC-insured institutions, and that the FDIC can examine the parent of an ILC to review the relationship between the parent and the ILC.

So where does that leave us? With the passage of Gramm-Leach-Bliley, and the existence of various affiliations between commercial firms and financial institutions – including ILCs – it may be that the debate over the separation of banking and commerce has reached a point where the central issue is not how to prevent commercial and financial combinations, but how to regulate them.