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After the Dodd-Frank Industrial Loan Company Moratorium: What’s Next?

V. GERARD COMIZIO*

I. INTRODUCTION

One of the many provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)\(^1\) that has wide-ranging implications for the financial services industry is section 603 of Title VI,\(^2\) which imposes a three year moratorium on the chartering or acquisition of industrial loan companies (ILCs) by commercial firms. The upcoming expiration of this moratorium on July 21, 2013 has reopened the debate on the future of the ILC.

ILCs, also known as industrial banks, are state-chartered banking institutions that emerged in the early twentieth century operating more or less as financial companies providing consumer credit to low and moderate income workers who were generally otherwise unable to obtain credit from commercial banks.\(^3\) As a

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2. Section 603(a)(2) states that the FDIC “may not approve an application for deposit insurance under section 5 of the Federal Deposit Insurance Act (12 U.S.C. 1815) that is received after November 23, 2009, for an industrial bank, a credit card bank, or a trust bank that is directly or indirectly owned or controlled by a commercial firm.” 12 U.S.C. § 1815 (Supp. IV 2010). See also infra notes 81-85.

3. See V. Gerard Comizio, Bank Chartering Issues in the New Millennium—Comparing Depository Holding Companies and Bank Charters, 56 CONSUMER FIN. L. Q. REP. 153, 153-77 (2002); see also Mindy West, The FDIC’s Supervision of Industrial Loan Companies: A Historical Perspective, 1 SUPERVISORY INSIGHTS 5, 8 (2004) [hereinafter FDIC Study] (noting that views expressed in SUPERVISORY INSIGHTS are those of the authors and do not necessarily reflect official positions of the FDIC, and in particular, should not be construed as definitive regulatory or supervisory guidance).
business matter, in most respects, ILCs may engage in most of the same activities as other depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) and thus may offer a full range of loans, including consumer, commercial and residential real estate, small business, and subprime.\(^4\) The regulation of the safety and soundness of ILCs rests with the FDIC and the ILC’s respective state charter regulator. ILCs are also generally subject to the same federal safety and soundness and consumer protection laws that apply to other FDIC-insured institutions.

Notably, under the Bank Holding Company Act (BHC Act),\(^5\) any company that controls a “bank,” as defined, is subject to prudential regulation as a bank or financial holding company by the Board of Governors of the Federal Reserve System (FRB), which has established a consolidated supervisory framework for bank holding company structures.\(^6\) However, ILCs are not defined as “banks” for the purposes of the BHC Act, and thus, companies that own or control ILCs operate under an exception to the BHC Act, and most are not subject to FRB oversight.\(^7\)

The ILC industry has experienced significant asset growth in recent years and has evolved from one-time, small, limited purpose institutions to a diverse industry that includes some of the nation’s largest and more complex financial institutions.\(^8\) Over the last decade a growing number of commercial entities have become increasingly interested in owning ILCs. For example, a number of large commercial

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7. See 12 U.S.C. § 1841(c)(2)(H); see also Saule T. Omarova & Margaret E. Tahyar, That Which We Call a Bank: Revisiting the History of Banking Holding Company Regulation in the United States, 31 REV. BANKING & FIN. L. 113 (2011). Moreover, to date the FDIC does not have consolidated supervisory authority over ILC holding companies. The FDIC has, however, employed what some term as a “bank-centric” supervisory approach that primarily focuses on isolating the ILC from potential risks posed by holding companies and affiliates, rather than assessing these potential risks systemically across the consolidated holding company structure. See U.S. Gov’t Accountability Office, GAO-05-621, GAO Rep. to the Honorable James A. Leach, H.R., Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, 18 (Sept. 2005) [hereinafter 2005 GAO Report], available at http://www.gao.gov/assets/250/247759.pdf.; see also discussion, infra Part II.E.
entities—primarily consumer retail companies—were granted approval to open ILCs in 2004. Wal-Mart, one of the largest retail enterprises in the United States, applied for an ILC charter at that time, triggering a robust public debate, including Congressional scrutiny, about whether ILCs ownership by commercial companies may expand beyond the original scope and purpose intended by Congress. In particular, the question debated was whether or not the ILC exception to the BHC Act constitutes a "loophole" in need of fixing.

In response to this public debate, the FDIC imposed a series of moratoriums on the chartering or acquisition of ILCs by commercial companies. Subsequently, Dodd-Frank adopted the additional three-year statutory moratorium, designed to provide time for further study of the relative merits of this exception and whether it was problematic. Interestingly, prior to Dodd-Frank, the status of ILCs had previously been addressed in a number of government studies, at times in the context of analysis of the overall regulation of the financial services industry. Products of a variety of economic, political and regulatory climates and circumstances over the years, these studies provide fascinating insight into the development of public policy and regulatory oversight of ILCs.

The article first analyzes the various government studies issued over the years regarding the ILC charter and its ownership by commercial firms, and also discusses the circumstances surrounding the FDIC moratoriums on ownership or acquisition of ILCs by commercial companies. Second, this article analyzes the relative merits of a wide range of options for resolving the complex policy, regulatory and competitive issues related to the ILC charter that will be presented upon expiration of the current moratorium.

9. Id.; see also JAMES R. BARTH AND TONG LI (WITH APANARD ANGKINAND, YUAN-HSIN CHIANG AND LI LI), MILKEN INSTITUTE, INDUSTRIAL LOAN COMPANIES: SUPPORTING AMERICA'S FINANCIAL SYSTEM (2011).
10. See id.; see also Eric Dash, Wal-Mart Abandons Bank Plans, N.Y. TIMES, Mar. 17, 2007, at Cl (indicating that three commercial firms recently received regulatory approval to form ILCs: retail stores Target (Target Bank) and Sears (Sears Bank) and automaker Toyota (Toyota Financial Savings Bank)).
11. See infra Part II.B.
12. See infra Part III.B.
II. ISSUES ABOUT ILCs PRIOR TO DODD FRANK

A. The Bush Task Force Report

During a recession in the early 1980s fueled by high interest rates that were a primary cause of the then-emerging savings and loan crisis, Vice President George H. W. Bush was appointed in 1982 by President Reagan to chair the Task Group on Regulation of Financial Services (the “Task Group”). The goal of the Task Group was to reform the federal financial regulatory system, primarily through developing “practical proposals to strengthen the effectiveness of federal regulation, while also encouraging competition and reducing unnecessary costs.” On July 2, 1984, the Task Group issued its report, entitled “Blueprint for Reform” (the “Bush Report”). The Bush Report set forth wide-ranging recommendations for broad restructuring and reform of the financial regulatory system, issuing a total of four dozen major recommendations.

On reform of the bank regulatory system, the report’s recommendations focused on (1) maintaining the dual banking system of state and federal banks, (2) restructuring supervision at the federal level so that there is only one federal regulator of state chartered banks, (3) having the agency regulating the lead bank of any banking organization also regulate its holding company, to eliminate “overlap and inefficiency,” and (4) having the FRB, as the nation’s central bank, “maintain a meaningful role in the regulatory system.”

Notably, within this framework, the Bush Report did not focus at all on issues of, or the need to reform, ILCs in any manner. This likely reflected the relatively small ILC industry in existence at that time. The ILC industry changed dramatically, however, over the next 30 years.

14. Id.
15. Id. at 10.
16. Id. at 11-12.
17. ILC assets totaled only $3.8 billion in 1987. 2005 GAO REPORT, supra note 7.
B. The FDIC ILC Moratorium

Between 1987 and 2004, ILC assets grew over 3,500 percent from $3.8 billion to over $140 billion. This dramatic increase can be attributed to the formation and acquisition of ILCs by both financial and commercial (i.e., nonfinancial) companies. In 2005, soon after Sears, Home Depot and Target had received ILC charters, Wal-Mart attempted to charter a Utah ILC—after first failing to acquire a California ILC—and sought federal deposit insurance from the FDIC. Many in the banking industry, Congress and some community groups objected to the Wal-Mart application citing, in part, the longstanding principle of separation of commerce and banking. In response to the emerging controversy and public debate over the Wal-Mart application, on August 1, 2006, the FDIC imposed a six-month moratorium on agency action with respect to applications for deposit insurance for any ILC, citing concerns regarding the lack of federal consolidated supervision, potential risks from mixing banking and commerce, and the potential for an “unlevel playing field” in the banking industry. The asserted purposes of the moratorium were to allow the FDIC to further evaluate industry developments, to determine whether ILCs present safety and soundness concerns or risks to the insurance funds, to evaluate the need for statutory, regulatory, or policy changes, and—at a more subtle level—give Congress an opportunity to react to the controversy if it so

18. Id.


chose.\textsuperscript{22}

The terms of the moratorium provided that the FDIC could not take any action to accept, approve, or deny any application for deposit insurance submitted to the FDIC by, or on behalf of, any proposed or existing ILC, or accept, disapprove, or issue a letter of intent not to disapprove any change control application or notice submitted to the FDIC with respect to any ILC.\textsuperscript{23} As such, the FDIC not only refused to act on pending applications to acquire an ILC or obtain deposit insurance for a newly formed ILC, but also refused to accept any new applications.\textsuperscript{24} The moratorium was to be in effect until January 31, 2007.

On January 31, 2007, the FDIC announced a one-year, partial extension of the moratorium.\textsuperscript{25} One of the reasons cited for the extension was pressure from Congress.\textsuperscript{26} Specifically, on December 7, 2006, 107 members of the House of Representatives sent a letter to the Chairman of the FDIC urging the agency to extend the moratorium for at least six months to “allow the 110th Congress an opportunity to act on this important public policy issue.”\textsuperscript{27}

The scope of the extended moratorium was narrowed, so that it applied only to applications for deposit insurance and change in control notices with respect to ILCs that will become subsidiaries of companies engaged in non-financial activities,\textsuperscript{28} i.e., commercial activities not

\begin{quote}
\textsuperscript{22} 71 Fed. Reg. at 43,483.
\textsuperscript{23} Id.
\textsuperscript{24} In fact, the moratorium specifically stated that, while the moratorium is in effect, “the FDIC will not ‘accept’ applications for deposit insurance for any ILC or notices of change in control with respect to any ILC, regardless of whether the application or notice is substantially complete.” Id.
\textsuperscript{25} See Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg. 5290, 5290 (Feb. 5, 2007). It remains an open – and intriguing – question as to whether the filing of a writ of mandamus against the FDIC regarding pending ILC applications would have caused a judicial confrontation over the legality of an extended moratorium period.
\textsuperscript{26} Id. at 5293.
\textsuperscript{28} For purposes of the extended moratorium, the term “financial activity” includes: (i) banking, managing or controlling banks or savings associations; and (ii) any activity permissible for financial holding companies under 12 U.S.C. § 1843(k), any specific activity that is listed as permissible for bank holding companies under 12 U.S.C. § 1843(c), as well as activities that the FRB has permitted for bank holding companies under 12 CFR §§ 225.28 and 225.86, and any activity permissible for all savings and loan holding companies under 12 U.S.C. § 1467a(c). The term “non-financial activity” is any other activity. The FDIC intends to follow the written guidance of the FRB and the Office of Thrift Supervision
\end{quote}
permissible for financial holding companies. Companies engaged in financial activities could continue to charter or acquire ILCs.

C. The FDIC’s Views on Supervision of ILCs

At the outset of the ILC debate and FDIC moratoriums, the FDIC issued a supervisory publication in 2005 entitled The FDIC’s Supervision of Industrial Loan Companies: A Historical Perspective (the FDIC Study). The FDIC’s Study discussed “historical and current perspectives of ILC supervision” and the chronology of ILC failures.

The FDIC Study recognized that some observers questioned whether current arrangements for overseeing the relationship between an ILC and its parent would provide sufficient regulatory safeguards if more extensive mixing of banking and commerce were permitted. In apparent support of “bank-centric” regulation, the FDIC Study noted that “strategies to monitor and control a bank’s relationship with affiliated and controlling entities are fundamental to effective bank supervision under any organizational form that banks adopt,” and that “[t]his principle is enshrined in U.S. banking legislation, bank regulation, and supervisory practice.” In terms of regulation, the (OTS) regarding permissible holding company activities in its interpretations of the term “financial activity” and to consult with the FRB and/or OTS before making any decisions. It should be noted that section 313 of Title III of Dodd-Frank abolished the OTS and transferred the powers and duties regarding regulation of savings and loan holding companies to the FRB.

30. Id.
31. FDIC Study, supra note 3, at 5.
32. Id.
33. Id.
34. Id. The FDIC Study was issued prior to the final crisis and the criticisms aimed by Congress and others at the now defunct OTS over its approach to holding company regulation of AIG, the parent company of AIG Bank, FSB. The OTS was alleged to have adopted in the late 1990s a so-called holding company “lite” policy focusing primarily on regulation of bank subsidiaries and their affiliate relationships. In any future debate over FDIC regulation of ILCs, this perceived similarity between holding company “lite” and “bank-centric” regulatory policies are likely to be raised, and, at minimum, may weigh in favor of providing the FDIC and, at minimum, may weigh in favor of providing the FDIC with consolidated regulatory authority. See Chana Joffe-Walt, Regulating AIG: Who Fell Asleep on the Job?, NPR (June 5, 2009, 11:10 AM), http://www.npr.org/templates/story/story.php?storyId=104979546 (noting OTS “taking blame” for failing to adequately regulate AIG as a savings and loan holding company at March 5, 2009 Senate hearings on collapse of AIG credit default savings portfolio); see also
FDIC Study stressed that stand-alone banks, savings associations, bank and thrift holding company subsidiaries, ILCs, and other FDIC-insured entities are subject to, among other regulations, Sections 23A and 23B of the Federal Reserve Act, which limits bank transactions with affiliates, including the parent company, and FRB Regulation O, which places limitations on loans to bank insiders and applies to all insured banks. Further, the FDIC Study noted that prompt corrective action regulations required under the Federal Deposit Insurance Act, as amended (FDI Act) mandate progressively severe sanctions against any insured bank whose owners fail to maintain adequate capitalization in that bank. The FDIC Study also stated that “[t]his array of safeguards reflects the importance Congress and the banking agencies attach to containing the potential cost of bank failures.”

The FDIC Study also contained a complete chronology of all ILC failures, and concluded that these bank failures were caused by various factors, including weak economic conditions, failed business strategies, insufficient oversight by boards of directors, fraud perpetrated by bank insiders, and the nature of the influence exerted by a holding company or other controlling entity. Further, it concluded that the problems that can cause a bank to fail “strike democratically across charter types and regulatory structures.” More specifically, the FDIC Study concluded that ILC failures reinforce the observation that appropriate safeguards over inter-affiliate transactions are important under any charter type.

The FDIC Study further observed that depending on the organizational form a banking company adopts, “federal oversight of


36. FDIC Study, supra note 3, at 5; Regulation O, 12 C.F.R. § 215 (2011) (loans to insiders); see also 12 C.F.R. § 337.3 (making Regulation O prohibitions and limitations on loans to insiders applicable to all insured nonmember banks).


38. See, e.g., 12 C.F.R. § 325 (focusing on nonmember banks).

39. FDIC Study, supra note 3, at 5.

40. Id. at 11–13.

41. Id. at 5–6.

42. Id. at 6.
the relationship between an insured bank and its affiliates may occur in two ways: bank supervision and holding company supervision,"\(^{43}\) and that "[b]ank supervision does not involve extensive federal banking agency oversight of controlling entities and their related interests."\(^{44}\) For example, the FDIC Study noted that if the controlling shareholder of a community bank also owns an automobile dealership, that dealership is not supervised by a federal banking agency.\(^{45}\) As such, the statutory, regulatory, and supervisory safeguards cited in the FDIC Study "are designed to prevent abuse of the bank by the owner, and the owner may be required to produce documents and financial records that detail the bank's relationship with the dealership."\(^{46}\)

As to holding company supervision, the FDIC Study noted the functional regulation aspects of the FRB's consolidated supervision of bank and financial holding companies.\(^{47}\) In this regard, the FRB clearly has had comprehensive and longstanding statutory authority, and experience in the regulation, examination and supervision of bank holding companies and their affiliates on a consolidated basis.\(^{48}\)

\(^{43}\) Id.

\(^{44}\) FDIC Study, supra note 3, at 6.

\(^{45}\) Id.

\(^{46}\) Id.

\(^{47}\) An ILC can be owned by a bank holding company, in which case the parent company is subject to FRB supervision. In addition to supervising bank holding companies, the FRB, under the Gramm-Leach-Biley Act of 1999, Pub. L. No. 106-102, Title I, 113 Stat. 1338, (GLBA) and Dodd-Frank, has consolidated supervisory powers with respect to financial holding companies. See also Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 604, 12 U.S.C. § 1844(c) (Supp. IV 2010) (providing the FRB with broad consolidated authority over bank holding companies and their subsidiaries).

In contrast, the FDIC Study observed that the FDIC in essence had neither the specific statutory authority, nor early on the experience to regulate, examine or supervise bank parent companies, noting that the early FDIC and state examinations of those ILCs with commercial parents that had obtained federal deposit insurance proved "challenging." 49 Examiners encountered management unaccustomed to regulatory oversight and sometimes unwilling to provide information. 50 "These entities operated as an extension of the parent, not as autonomous, federally insured and regulated banks. It became apparent that such ILCs needed to be introduced to and helped to understand the specifics of banking regulation and corporate governance of the separate ILC entity." 51 The FDIC Study concluded that ILC senior management must be held accountable for ensuring that all bank operations and business functions are performed in compliance with banking


49. FDIC Study, supra note 3, at 9.

50. Id. For example, examiners frequently could not identify local officers with decision-making authority or find records, including loan documentation, on site.

51. Id.
regulations and in a safe and sound manner.\textsuperscript{52}

The FDIC Study also noted that "[t]he FDIC has developed conditions that may be imposed when approving deposit insurance applications for institutions that will be owned by or significantly involved in transactions with commercial or financial companies."\textsuperscript{53}

\textsuperscript{52} To guarantee sufficient autonomy and insulate the bank from the parent, the state authority, the FDIC, or both typically impose certain controls. The FDIC Study cited one example of "proactive state supervision:"

[T]he Utah Department of Financial Institutions ("DFI"), which imposes conditions for approval of new industrial bank charters, gives considerable weight to the following factors:

- The organizers have solid character, reputation, and financial standing.
- The organizers have the resources (source of capital) to support an ILC.
- The selection of a board of directors, the majority of whom must be outside, unaffiliated individuals, and some of whom must be Utah residents.
- The establishment of a Utah organization where autonomous decision-making authority and responsibilities reside with the board and management such that they are in control of the ILC's activities and direction.
- Management that has a track record and the knowledge, expertise, and experience in operating a depository institution in a regulated environment.
- Management that is independent of the parent; however, the goals and policies of the parent may be carried out if defined in the ILC's business plan.
- A bona fide business plan and purpose for the existence of an ILC, in which deposit-taking is an integral component, including three years' pro forma projections and supporting detail.
- FDIC deposit insurance.
- All ILC lending and activities must comply with Sections 23A and 23B of the Federal Reserve Act (restrictions on transactions with affiliates) and Federal Reserve Regulation O (loans to executive officers, directors, or principal shareholders).


\textsuperscript{53} A sampling of the "nonstandard conditions" that the FDIC may require include:

- The organizers will appoint a board of directors, the majority of whom will be independent of the bank's parent company and its affiliated entities.
- The bank will appoint and retain knowledgeable, experienced, and independent executive officers.
- The bank will develop and maintain a current written business plan, adopted by the bank's board of directors that is appropriate to the nature and complexity of the activities conducted by the bank and separate from the business plan of the affiliated companies.
- To the extent management, staff, or other personnel or resources are employed by both the bank and the bank's parent company or any affiliated entities, the bank's board of directors will ensure that such arrangements are governed by
The FDIC Study also noted that

[a]s with any bank-level review of an institution with affiliates, examination procedures include an assessment of the bank's corporate structure and how the bank interacts with the affiliates (including a review of intercompany transactions and interdependencies) as well as an evaluation of any financial risks that may be inherent in the relationship. Examiners review the current written business plan and evaluate any changes.54

In examining any insured depository institution, the FDIC Study also stressed that the FDIC has the authority under Section 10(b) of the FDI Act to examine any affiliate of the institution, including the parent company, for purposes of determining (i) the relationship between the ILC and its parent and (ii) the effect of such a relationship on the ILC. Further, Section 10(c) of the FDI Act empowers the FDIC, in the course of its supervisory activities, to issue subpoenas and to take and preserve testimony under oath, so long as the documentation or information sought relates to the affairs or ownership of the insured institution.55

written contracts giving the bank authority and control necessary to direct and administer the bank's affairs.

See FDIC Study, supra note 3, at 10 (emphasis added) (citing Regional Director Memorandum (RDM) 2004-11, Imposition of Prudential Conditions in Approvals of Applications for Deposit Insurance, dated Mar. 12, 2004)).

54. The FDIC Study noted that FDIC examiners review, among other things: any arrangements involving shared management or employees. In the latter case, referred to as "dual employees," agreements should be in place that define compensation arrangements, specify how to avoid conflicts of interest, establish reporting lines, and assign authority for managing the dual-employee relationship. All services provided to or purchased from an affiliate must be on the same terms and conditions as would be applied to nonaffiliated entities. All service relationships must be governed by a written agreement, and the bank should have a contingency plan for all critical business functions performed by affiliated companies. FDIC Study, supra note 3, at 10.

55. The FDIC Study noted that “[a]ccordingly, individuals, corporations, partnerships, or other entities that in any way affect the institution's affairs or ownership may be subpoenaed and required to produce documents.” FDIC Study, supra note 3, at 10-11; See 12 U.S.C. § 1820(b) (Supp. V 2011); 12 U.S.C. § 1820(c) (2006).
In addition, the FDIC Study noted that the three states with the most ILCs under regulation—Utah, California, and Nevada—also “have direct authority to conduct examinations of parents and affiliates.”

**D. CRS Report for Congress on ILCs**

In mid-2005, the Congressional Research Service (CRS) released a report on ILCs (the CRS Report). The CRS Report, in providing context for the ILC “controversy,” provided a historical overview of the separation of banking and commerce, examined the “nature” of ILCs and their regulation, and analyzed relevant legislation in Congress.

In so doing, the CRS Report concluded that ILCs evoke two major policy questions: first, should Congress grant ILCs powers that “would allow them to be nationwide banks while in competition with community banks?” and second, could the combination of state and FDIC regulation provide oversight “comparable to that for nationwide banks, especially to bank holding companies?”

Among other things, the CRS Report noted that “[t]he ILC form reflects a persistent tendency to combine the financing of a business

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56. FDIC Study, supra note 3, at 11. The Utah DFI “requires all parent companies to register with the state under Section 7-8-16 of the Utah Code and has authority to examine such companies under Section 7-1-510.” Id. at n. 15. See Utah Code Ann. §§ 7-8-16, 7-1-510 (2006). The California Department of Financial Institutions has authority to examine parent organizations and to require reports and information through Section 3703. See Cal. Fin. Code. §§ 21-3703-4 (West 2012). “In the state of Nevada, holding companies are required to register with the Secretary of State,” and the Nevada Financial Institutions Department has the authority to conduct examinations of parent organizations. See Nev. Rev. Stat. Ann. § 658.185 (2009).


58. Id. at 2-11.

59. Id. at 1.

The 108th Congress considered these issues in two bills that passed the House. H.R. 758 would have allowed ILCs to provide and pay interest on business checking accounts, while H.R. 1375 would have allowed ILCs to open branches even without permission from the states of the new branches. Taken together, such measures could have transformed ILCs into a parallel banking system regulated primarily by a few states, yet allowing ILCs to grow into large institutions with commercial ownership. In 2005, Wal-Mart announced that it is again applying for an ILC charter, thus affecting any banking “regulatory relief” legislation in the 109th Congress. [Following this announcement,] H.R. 1224, allowing business checking accounts in a way to prevent ILCs owned by nonfinancial businesses from becoming more bank-like via new accounts, passed the House on May 24, 2005, [but died in the Senate]. Id.
with its operations, . . . standard in many countries, especially Germany and Japan, but [which has] generally fallen into disfavor in America."\(^{60}\) The CRS Report concluded, therefore, that ILCs “have developed against a long U.S. tradition of the separation of banking and commerce.”\(^{61}\) The CRS Report also presented a number of arguments for and against ILCs.\(^{62}\)

E. The 2005 GAO Report

Also in the context of the 2005 ILC debate, the Government Accountability Office (GAO), at the request of then Congressman James Leach, chairman of the House Financial Services Committee, conducted a study of ILC regulation, and proposed recommendations regarding the ILC regulatory scheme.\(^{63}\) “To better ensure that supervisors of institutions with similar risks have similar authorities,” the 2005 GAO Report concluded that Congress should consider various options for regulating ILCs such as (1) eliminating the current exclusion for ILCs and their holding companies “from consolidated supervision” by the FRB, (2) granting the FDIC “similar examination and enforcement authority as a consolidated supervisor,” or (3) “leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.”\(^{64}\)

In addition, the 2005 GAO Report recommended that Congress more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity significantly more than the holding companies of other types of financial institutions is warranted or whether other entities should be permitted

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60. Id.
61. The CRS Report stated that “ownership interests that nonfinancial firms may have in banks are generally 25% or less. Banks may generally hold only nominal amounts of corporate stock.” Id.
63. 2005 GAO REPORT, supra note 7, at 1.
64. 2005 GAO REPORT, supra note 7, at 9.
to engage in this level of activity.\textsuperscript{65}

In written comments to the 2005 GAO Report, the FRB concurred with the report’s findings and conclusions insofar as it accorded with the FRB’s views that “[c]onsolidated supervision provides important protections to the insured banks that are part of a larger organization, as well as the federal safety net that supports those banks” and that the report “[p]roperly highlights the broad policy implications that ILCs raise with respect to maintaining the separation of banking and commerce.”\textsuperscript{66}

In written comments from the FDIC, the FDIC concurred with the 2005 GAO Report insofar as it concluded that-ILCs do not appear to have a greater risk of failure than other types of insured depository institutions but generally believed that no changes were needed in its supervisory approach over ILCs and their holding companies, and disagreed with the matters for congressional consideration.\textsuperscript{67} Specifically, [the] FDIC’s disagreements focused on three primary areas—whether consolidated supervision of ILC holding companies is necessary to ensure the safety and soundness of the ILC; that FDIC’s supervisory authority may not be sufficient to effectively supervise ILCs and insulate insured institutions against undue risks presented by external parties; and the impact that consolidated supervision of ILCs and their holding companies would have on the marketplace and the federal safety net.\textsuperscript{68}

The FDIC conceded, however, “that consolidated supervision offers broader examination and enforcement authorities that may be
used to understand, monitor, and when appropriate, restrain the risks associated with insured depository institutions in a holding company structure”—in essence, a “we don’t need it, but we’d be glad to have it” approach.69

F. The U.S. Department of The Treasury Blueprint for a Modernized Financial Regulatory Structure

Following a conference on capital markets competitiveness in March 2007, the U.S. Department of the Treasury conducted a study on the regulatory structure of the financial system, which was released in March 2008 as a new “blueprint” for a modernized financial regulatory structure (the Treasury Blueprint).70 The Treasury Blueprint provided “short-term” and “intermediate-term” recommendations for “improving and reforming” the U.S. regulatory structure. The “short term” recommendations focused on improving “regulatory coordination and oversight” in the wake of the then-emerging financial crisis, and the “intermediate-term” recommendations focused on “eliminating some of the duplication of the U.S. regulatory system but more importantly trying to modernize the regulatory structure applicable to certain sections in the financial services” system, namely banking, insurance, securities, and futures.71

Interestingly enough, notwithstanding the intensity of the legislative, banking agency, and banking industry debate prior to the financial crisis on the issue of the future availability of the ILC charter to commercial companies, ILCs received a light—and somewhat favorable—touch in the Treasury Blueprint. In a wide-ranging section of the report entitled “Chartering and Regulation of Depository Institutions,” the Treasury Blueprint identified that the key issue of “[a]llowing a [federally insured depository institution (FIDI)] to affiliate with a commercial firm raise[d] the longstanding debate in the [U.S.] about allowing for a broader mix of banking and commerce.”72 The Treasury Blueprint noted that “[p]roponents of allowing FIDIs to affiliate with commercial firms generally point to several reasons: the

69. Id. at 10, 84.
71. Id. at 1–3.
72. Id. at 164.
potential for increased competition and innovation, safety and soundness benefits of diversification, adequate protection of a FIDI through separation and firewalls, and antitrust protections against improper exercise of economic power.”

Similarly, the Treasury Blueprint noted that “[o]pponents raise several other concerns: increased safety and soundness risks (related to the [perceived] ineffectiveness of firewalls), undue concentration of economic power, conflicts of interest in credit allocation, misallocation of resources in the economy, and inappropriate extension of the federal safety net.”

Significantly, the Treasury Blueprint stressed that “[i]n evaluating the issue of commercial affiliations with FIDIs, it is important to note that the [Gramm-Leach-Bliley Act (GLBA)] had already permitted broader affiliations between insured depository institutions and other financial firms though a financial services holding company framework,” and, as such, “[c]oncerns regarding the transfer of the ‘safety net’ should not differ for financial or commercial firms.”

The Treasury Blueprint noted that “[o]ne key difference is that, in general, financial affiliates are subject to some degree of financial regulation while commercial firms are not.” The Treasury Blueprint observed

[that might provide some comfort in terms of risks an affiliate may pose to a FIDI, but the history of commercial firms affiliating with insured depository institutions has not supported the view of greater risks present in such structures. The enhanced individual bank oversight authority provided to [a bank’s primary federal regulatory agency (PFRA)—“bank-centric” regulation—] is designed to address the range of concerns existing across all types of affiliations with FIDIs.

The Treasury Blueprint also noted that “[h]olding company

73. Id.
74. Id.
75. Id. (emphasis added)
76. Treasury Blueprint, supra note 70, at 164.
77. Id. (emphasis added).
regulation was designed to protect the assets of the insured depository institution and to prevent the affiliate structure from threatening the assets of the insured institution. However, some market participants view holding company supervision as intended to protect non-bank entities within a holding company structure.\textsuperscript{78} In the "optimal structure," the Treasury Blueprint concluded that "PFRA will focus on the original intent of holding company supervision, protecting the assets of the insured depository institution; and a new market stability regulator will focus on broader systemic risk issues."\textsuperscript{79} The Treasury Blueprint asserted the Treasury's "belief that a combination of enhanced oversight of affiliate relationships by the prudential regulator and a market stability regulator with the appropriate expertise and authority to harness market forces provides the most effective and efficient method of supervision."\textsuperscript{80}

In summary, the Treasury Blueprint clearly provided a blueprint for the continued and perhaps expanding ownership of FIDIs by commercial firms through prudential, "bank-centric" oversight of affiliate relationships by the FIDI's PFRA.

III. ILCS AFTER DODD-FRANK

A. The Dodd-Frank Moratoriums

Section 603 of Dodd-Frank establishes a three-year moratorium, with a sunset date of July 21, 2013, prohibiting the FDIC from approving any application for deposit insurance received after November 23, 2009 for an industrial loan bank or certain other depository institutions (credit card banks and trust banks) (collectively "industrial banks") exempt from the definition of "bank" under Section 2 of the BHC Act, if they would be directly or indirectly owned or controlled by a commercial firm.\textsuperscript{81} Since these institutions are not treated as "banks" under the BHC Act, they may be owned by a company that is engaged in nonfinancial activities, and thus, do not

\textsuperscript{78} \textit{Id.}
\textsuperscript{79} \textit{Id.}
\textsuperscript{80} \textit{Id.} at 164-65.
qualify as a bank holding company under the BHC Act.

For purposes of this moratorium, a company is a "commercial firm" if the annual gross revenues derived by the company and all its affiliates from activities that are not "financial in nature," as defined under Section 4(k) of the BHC Act as permissible activities for financial holding companies regulated by the FRB, represents more than 15 percent of the consolidated annual gross revenues of that company.\(^8\) Consolidated revenues include the ownership or control of one or more depository institutions.\(^8\)

Subject to certain exceptions, the FDIC may not approve an acquisition or change in control of an ILC by a commercial firm.\(^8\)

**B. Dodd-Frank Act GAO Study of ILC Exemptions Under the BHC Act**

Section 603 also required that the Comptroller General of the GAO to "carry out a study to determine whether it is necessary, in order to strengthen the safety and soundness of the institutions and the stability of the financial system, to eliminate" the industrial loan bank exception under section 2 of the BHC Act.\(^8\) The study was required to

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84. See 12 U.S.C. § 1815 (Supp. V 2011). There are certain limited exceptions to this moratorium for a change in control:
   - involving an industrial bank "in danger of default," as determined by the appropriate federal banking agency ("AFBA"); that "results from the merger or 'whole' acquisition of a commercial firm that directly or indirectly controls the industrial bank," in a "bona fide" merger with another commercial firm, as determined by the AFBA; or
   - that "results from the acquisition of voting shares of a publicly traded company," if, after the acquisition, (a) the company shareholder (or group of shareholders acting in concert) hold less than 25 percent of any class of voting stock of the company, and (b) has obtained all regulatory approvals required for such change in control under applicable federal or state law. Id.
85. Id. The study’s content “to the extent feasible” must “be based on information provided to the Comptroller General by the appropriate federal or state regulator,” and must address the following:
   - “identify the types and number of institutions currently [exempted] from Section 2 of the [BHC Act];”
   - generally describe the size and geographic locations of the institutions;
   - “determine the extent to which the institutions... are held by holding companies that are commercial firms;
   - determine whether the institutions described... have any affiliates that are commercial firms;
be submitted to Congress no later than eighteen months from the date of enactment of Dodd-Frank.\textsuperscript{86}

On January 19, 2012, the GAO published its study (the 2012 GAO Study).\textsuperscript{87} The study found that exempt banks include industrial loan corporations, limited-purpose credit card banks, trust institutions with insured deposits and thrifts and that removal of these exemptions would likely cause these parent companies to be regulated as bank holding companies under the BHC Act.\textsuperscript{88} Due to the non-banking nature of their businesses, some of these parent companies would be unable to meet the requirements of the BHC Act, primarily the requirements to be engaged only in financially related activities.\textsuperscript{89}

Further, the study found that because exempt banks make up a small percentage of the overall banking system, and vary by size, activities and risk profile, removing these exemptions would likely have little impact on the U.S. credit markets because of the small percentage of assets held by these exempt banks.\textsuperscript{90}

As to the views of the federal bank regulatory agencies, the FDIC and the Office of the Comptroller of the Currency (OCC), which are responsible in part for regulating these exempt banks (but not their parent holding companies) believe the exemptions need not be removed because the current oversight regime for these institutions "is sufficiently robust."\textsuperscript{91} The FRB believes the exemptions should be

\begin{itemize}
  \item identify the Federal banking agency responsible for the supervision of the institutions ... on and after the transfer date;
  \item determine the adequacy of the Federal bank regulatory framework applicable to each category of institution ... including any restrictions (including limitations on affiliate transactions or cross-marketing) that apply to transactions between an institution, the holding company of the institution, and any other affiliate of the institution; and
  \item evaluate the potential consequences of subjecting the institutions ... to the requirements of the [BHC Act,] including with respect to the availability and allocation of credit, the stability of the financial system and the economy, the safe and sound operation of each category of institution, and the impact on the types of activities in which such institutions, and the holding companies of such institutions, may engage." \textit{Id.}
\end{itemize}

\textsuperscript{86} \textit{Id.}
\textsuperscript{88} \textit{Id.} at 1, 53.
\textsuperscript{89} \textit{Id.} at 1.
\textsuperscript{90} \textit{Id.} at 36-41.
\textsuperscript{91} \textit{Id.} at 1, 30.
removed and that the holding companies of all FIDIs should be subject to full BHC Act regulation. The FRB also raised concerns that if the exemptions remain intact, companies owning exempted banks may grow large enough in the future to pose significant risks to the U.S. financial system.

Interestingly enough, less than four years after the Treasury Blueprint was issued—in which the Treasury essentially took the position that enhanced oversight of ILC affiliate relationships by the primary regulator would provide the “most effective and efficient method of supervision,” the U.S. Treasury now apparently expressed its opinion that the exemptions should be removed.

C. After the Dodd-Frank Moratorium: What’s Next?

The Dodd-Frank moratorium on ILCs being owned or chartered by nonfinancial companies expires on July 21, 2013. The important question is what will happen once the moratorium expires. The most likely probabilities are a legislative extension of the moratorium, or the terms and conditions, if any, under which Congress would let the moratorium lapse. Either scenario may result in a potential repeat of the 2005 debate about the ILC charter. The real question, though, is whether it is possible for a different and more productive debate to occur on the relative merits of the ILC charter that could benefit the financial services industry as a whole—and its competitive realities—and also satisfy potential regulatory concerns.

The CRS Report aptly observed the following about the ILC debate:

Debate over measures granting ILCs banking powers, without requiring that their owners be bank holding companies, involves interrelated questions. They

92. Id.
94. See infra text accompanying note 85.
95. 2012 GAO Study, supra note 87, at 57.
97. Notably, any debate in the near future will likely be impacted by the current regulatory climate in the wake of the global financial crisis and resulting financial reform legislation.
involve competitive equality, the nature and effectiveness of regulation, and safety and soundness issues. Comparisons of ILCs and banks involve value judgments as to the safety and competitiveness of banking institutions, federalism, and relations between ownership and behavior.  

In this light, the following is hopefully a fair summary of the arguments for and against ILC expansion.

The FDIC, OCC, and state regulators have argued that ILCs and other BHC Act-exempt FDIC insured banks are subject to their respective bank-centric regulation: examinations, compliance with banking laws, and supervisory restrictions, and have been successfully regulated as a general matter. In this view, no safety and soundness reasons exist requiring constraints on this charter type beyond those imposed on other FDIC-insured institutions.

Further, the nation's state banking regulators, through their organization, "the Conference of State Bank Supervisors, and the Financial Services Roundtable believe in the potential for competitive flexibility of ILCs, with their state charters forming just another part of the 'dual banking system' of federal and state banking charters." Whether that support for the ILC charter extends to ownership by nonfinancial companies, though, is less clear.

It also has been argued that ILCs have not experienced the extent of problems that the rest of the banking industry has over the years, and ILC parent companies have generally served successfully as significant sources of strength to the operations and capital of their ILC.

98. CRS Report, supra note 57, at 10.
subsidiaries. As such, the argument is essentially that "if it ain't broke, don't fix it."

Finally, the Treasury Blueprint presented the case for bank-centric regulation of ILCs—allowing ILC ownership by nonfinancial companies as long as prudential "firewalls" on affiliate relationships are in place.

Despite the fact that a "who's who" of domestic and international corporations, retail stores, and auto companies have obtained ILC and other "non-bank" charters in the last twenty years without incident, Wal-Mart's application for an ILC charter in 2005 seemed to have been the straw that broke the camel's back for the banking industry and its regulators.101

In *Industrial Loan Companies Come Out of the Shadows*, Michelle Clark Neely notes the following concerns of regulators with regard to ILC charters:

> Most of the criticism leveled at the ILC industry centers on commercial ownership and can be boiled down to its effects on competition and safety and soundness.102 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 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.103

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101. See *Examining the Regulation and Supervision of Industrial Loan Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. 1* (2007) (statement of Scott Alvarez, General Counsel, Board of Governors of the Federal Reserve System) [hereinafter Alvarez Statement].


103. Neely Article, *supra* note 102, at 2-3. The ongoing debate in the U.S. about the mixing of banking and commerce revolves around "risks that far outweigh any benefit." *Id.* at 3. Those perceived risks include conflicts of interest, a lack of impartiality in credit
Large bank holding companies have strongly argued that parent companies of all banking institutions should be regulated in a similar manner, and be permitted to engage in similar activities, subject to prudential limitations. Under current law, banks assert that ILCs put bank holding companies at a competitive disadvantage because ILC parent companies are not regulated as bank holding companies, and financial holding companies cannot engage in commercial activities.\footnote{104}

Community banks feel threatened by potential competition from deep-pocket owners of ILCs with nationwide banking powers, expressing significant concerns that large retail stores will harm community banking, particularly in smaller towns and rural areas, just as small merchants and labor groups feel threatened by entry of large
decisions, the creation of monopoly power and an expansion of the federal safety net. \textit{Id} at 2-3. The Neely Article notes:

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 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. (footnote omitted). \textit{Id.}

\footnote{104. Neely Article, \textit{supra} note 102, at 3.}
POST-ILC MORATORIUM—WHAT’S NEXT

retail stores into their communities. Nonetheless, it is noteworthy that a number of community banks have partnered with large retail stores.

The FRB, in opposing ILC expansion, argues that ILCs and, especially, their owners, are not subject to the same supervision as commercial banks and their holding companies, and, would therefore, pose a risk to the financial system if they became prominent. The FRB has particularly expressed concern that owners of ILCs, especially large commercial firms, avoid regulations that apply to holding company owners of “full service” insured banks.

Finally, the CRS Report noted that “some consumer groups feel that ILCs threaten the FDIC insurance fund, and, therefore taxpayers, by mixing banking with commerce.”

III. POSSIBLE OPTIONS FOR RESOLVING THE ILC DEBATE

A. Extend the Moratorium

In a quintessential example of kicking the can down the road, the Congress could opt to extend the current moratorium for a yet to be determined period of time upon its expiration on July 21, 2013. The primary advantage of this strategy is that it avoids a confrontation, and, for better or worse, is certainly consistent with government actions in recent years in addressing this issue, beginning with the first FDIC ILC moratorium in 2006. The rationale for such an extension could be based on the conclusion that ILCs have been a declining issue in recent years, dropping in number and size since 2006 from 58 to 34, with total ILC assets dropping from $212.7 billion to $102.4 billion, well less than one percent of the assets of all FDIC-insured banks. This could also keep

105. Id. See also CRS Report, supra note 57, at 11 (summarizing opposition to ILC expansion).


107. See Alvarez Statement, supra note 101.

108. Id.

109. See CRS Report, supra note 57, at 11 (summarizing opposition to ILC expansion).

110. 2012 GAO Study, supra note 87, at 15–16. The GAO Report noted that during the 2007-2009 financial crisis, a number of the larger ILC holding companies applied and were approved to become bank holding companies in order to take advantage of government
lobbyists for the various parties engaged on the issue for a number of years. Moreover, a moratorium extension will likely be acceptable to the banking industry and the FRB to the extent it continues to prohibit expansion of the ILC industry.

Some of the disadvantages of a moratorium extension are obvious and others are less obvious. First, this option clearly does not address the long-term resolution of ILCs or the basket of other BHC Act-exempt holding companies owning FDIC-insured banks, which make up seven percent of the total assets in the U.S. banking industry and that were also required by Dodd-Frank to be addressed in the 2012 GAO study.111 Second, a moratorium extension does not acknowledge capital, funding and liquidity programs available to bank holding companies during the crisis. Id. These companies included American Express Company, Goldman Sachs Group, Inc.; Morgan Stanley and GMAC Financial Services. Merrill Lynch & Co. also owned an ILC that became part of Bank of America Corporation, a bank holding company, when it acquired Merrill Lynch in 2008. Id. at 16

111. Id at 16. For various reasons, the BHC Act exempts from regulation certain companies that own depository institutions; these subsidiaries are not defined as banks for purposes of the BHC Act and thus the companies that own them are not considered bank holding companies and are not required to comply with the BHC Act’s restrictions. Only one type of these companies—savings and loan holding companies—is subject to regulation at the holding company level, as follows:

- **Industrial loan corporations.** Industrial loan corporations (ILC) are limited-service financial institutions that make loans and raise funds by selling certificates called “investment shares” and by accepting deposits. ILCs are distinguished from finance companies because ILCs accept deposits in addition to making consumer loans. ILCs also differ from commercial banks because most ILCs do not offer demand deposit (checking) accounts. An exempt ILC either must not engage in any activity it was not lawfully engaged in as of March 5, 1987, or must be organized under state law either extant or contemplated by the state legislature as of March 5, 1987, requiring ILCs to be FDIC insured and meet one of the following conditions: (1) not accept demand deposits, (2) have total assets of less than $100 million, or (3) not have been acquired after August 10, 1987. 12 U.S.C. § 1841(c)(2)(H) (2006).

- **Limited-purpose credit card banks.** Limited-purpose credit card banks are generally restricted to credit card lending, can maintain only one office that accepts deposits, cannot accept demand deposits or transaction accounts, do not accept savings or time deposits of less than $100,000 (unless used as collateral for extensions of credit), and do not engage in the business of making commercial loans (other than small business loans).

- **Municipal deposit banks.** Municipal deposit banks are state-chartered institutions that are wholly owned by thrift institutions or savings banks and restrict themselves to acceptance of deposits from thrift institutions or savings banks, deposits arising out of the corporate business of their owners, and deposits of public monies. The BHC Act does not exempt municipal deposit banks from the definition of
the international competitive aspects of the mixing of commercial and banking businesses in other countries with well-developed banking systems. Third, it does not acknowledge the relatively successful safety and soundness track record of ILC ownership by nonfinancial companies. Fourth, it ignores the clear views of the Treasury Blueprint on this issue, which seemed to consider the issue as one of establishing the appropriate level and type of prudential "firewalls" governing a bank’s affiliate relationships with its commercial parent

"bank." Instead, companies that own or control municipal deposit banks are not defined as bank holding companies. 12 U.S.C. § 1841(a)(5)(E) (2006). For purposes of this report, however, municipal deposit banks are referred to as exempt institutions. These banks have generally not fallen within the debate on holding company regulation since they are generally owned by bank or savings and loans ("S&L") holding companies, and as such, the FRB has been cooperative in granting exception from the BHC Act since they are generally viewed as divisions of their parent banks.

- **Savings and loans or thrifts.** S&Ls or thrifts are institutions that traditionally accepted deposits to channel funds primarily into residential mortgages. More recently, these institutions’ charters have been expanded to allow them to provide commercial loans and a broader range of consumer financial services. The BHC Act defines exempt S&L associations as (1) any federal savings association or federal savings bank; (2) any building and loan association, savings and loan association, homestead association, or cooperative bank if such association or cooperative bank is a member of the Deposit Insurance Fund; or (3) any savings bank or cooperative bank that was previously deemed by the Director of the Office of Thrift Supervision to be a savings association under Section 10(I) of the Home Owners’ Loan Act. 12 U.S.C. §§ 1841(c)(2)(B) (2006); 1841(j) (2006). A residential mortgage is a document signed by a borrower when a home loan is made that gives the lender a right to take possession of the property if the borrower fails to pay off the loan. As discussed in detail later in this report, S&L holding companies are regulated by the FRB and are subject to restrictions on the activities they conduct.

- **Trust banks.** Trust banks are institutions that function solely in a fiduciary capacity. All or substantially all of the deposits of such institutions must be in trust funds. Trust banks must not permit insured deposits to be marketed through affiliates and may not accept demand deposits. Trust banks may not obtain payment services or borrowing privileges from the FRB. For this study, we identified only those trust banks that fell under the BHC Act exemption, (12 U.S.C. § 1841(c)(2)(D)) and that accept insured deposits. Serving in a fiduciary capacity includes serving as trustee, executor, custodian, administrator, registrar of stocks and bonds, guardian of estates, or committee of estates and incompetents. Dodd-Frank excluded companies that control limited-purpose trust savings associations from regulation as S&L holding companies.


company and its affiliates, rather than a fundamental concern about mixing banking and commerce. Finally, this approach may presume that continued moratoriums may render ILCs a non-issue, i.e., to the extent it presumes that ILCs will likely disappear at some point. There is no empirical evidence to support this premise, however, and ILC industry assets, even under a continued moratorium, could grow.

B. Let the Moratorium Expire

1. Permit only financial services companies to acquire or charter ILCs

Permitting only companies that are engaged in financially related activities to acquire or charter ILCs seems to only heighten the potential charge of regulatory arbitrage in bank holding company regulation raised by the FRB and the banking industry. To critics, justifying the ILC charter on the basis of “bank-centric” supervisory oversight without consolidated oversight powers of a financial company parent will be read to mean holding company “lite” regulation despite the FDIC’s fairly successful track record to date regulating ILCs. While bank charter choice and a dual banking system remain central features of the U.S. banking system, choice of bank holding company regulation and regulator has been virtually eliminated under Dodd-Frank, other than the current exemptions to the BHC Act. Further, this approach clearly does not address the main issue: whether nonfinancial, i.e., commercial firms should be permitted to own banks.

However, options exist that would permit all companies to acquire or charter ILCs and permit financial holding companies to engage in certain “nonfinancial” activities

113. Treasury Blueprint, supra note 70, at 203. See discussion supra Parts II.F.
114. 2012 GAO Study, supra note 87, at 15 (noting that regulators considered the ILC moratorium to be the most important factor in the decline in ILC institutions and assets since 2006).
115. It has been argued that the now-defunct OTS utilized this approach in its holding company supervision, a premise that formed part of Congress’s reasoning in eliminating the agency under Dodd-Frank. See FDIC Study supra note 3.
2. Provide FDIC consolidated supervisory powers over ILC parent companies

This approach seems consistent with one of the proposals in the 2012 GAO Study. Providing the FDIC with a level of supervisory power similar to the FRB over ILC parent companies would certainly be viewed as enhancing regulatory consistency in bank holding company regulation. However, it would still pose the “challenges” that both the FDIC and FRB have raised about how to regulate nonfinancial companies. Perhaps more significantly, this approach does not address the disparity in permissible activities that concerns the banking industry, i.e., ILC parent companies may engage in nonfinancial activities, while FRB regulated bank and financial holding companies may not. Finally, the FRB may likely argue that this approach is inconsistent with its consolidated bank holding company supervisor role under Dodd-Frank.

3. Require intermediate holding companies

Dodd-Frank provides that in the case of FRB-supervised nonfinancial companies that are not subject to the limitations on nonfinancial activities, the FRB may require the company to establish and conduct all or a portion of its permissible financial activities in or through an intermediate holding company (IHC) subsidiary interposed between the bank and its nonfinancial parent company. The FRB also may require any FRB-supervised nonbank financial company to establish an IHC if the FRB determines it necessary for appropriate supervision of the company’s financial activities or to ensure that FRB supervision does not extend to the commercial activities of the nonbank company. The FRB has a mandate “promulgate regulations to establish criteria for determining when IHCs will be required.”

A company that directly or indirectly controls an IHC is

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117. See 2012 GAO Study, supra note 87, at 43.
118. For example, a number of S&L holding companies regulated by the FRB are grandfathered under the GLBA, and may engage in nonfinancial activities.
120. Id.
required to serve as a source of strength to its subsidiary IHC. The FRB may require reports from the parent company of an IHC solely for purposes of assessing the company’s ability to serve as a source of strength to its subsidiary and to enforce compliance.\footnote{See 12 U.S.C. § 1467b (Supp. V 2011).}

Given the current use of IHCs, the question is whether the banking and ILC industries can agree on the use of IHCs to permit companies engaged primarily in nonfinancial activities to own banks, and, perhaps more significantly, permit a financial holding company to engage in nonfinancial activities through an IHC. More importantly, even if the industries agreed on this approach, it is unclear whether Congress and the FRB ultimately can be convinced that mixing banking and commerce through the use of the IHC is sound public policy. Until the current regulatory climate in the wake of the financial crisis and the landmark Dodd-Frank reform legislation subsides, this is likely to be a tough sell, but the relative merits from a competitive, regulatory and industry perspective maybe compelling in the longer term.

4. Redefine “financial in nature” under 4(k) of the BHC Act and permit certain retail activities for financial holding companies

The GLBA was designed to bring peace to the financial services world by permitting the mixing of banking, insurance, and securities activities i.e., “financially related activities.” In considering GLBA, however, legislators, financial services regulators, and financial industry trade groups, also seemed to agree at that time on one longstanding activity restriction engrained in banking regulation: no mixing of “financial services” and “commerce.”\footnote{See, e.g., Christine Blair, The Mixing of Banking and Commerce: Current Policy Issues, 16 FDIC BANKING REV. 97 (Jan. 2005).} In doing so, the GLBA purported to maintain a Maginot Line between financial services and commerce.

Meanwhile, over the last forty years commercial companies of all types have been entering the financial services business. As early as the 1960s, retail stores began to issue store credit cards, cash checks, and lend money on lay away plans, and auto companies and dealers began to finance auto purchases.\footnote{See Federal Reserve Board, Report to the Congress on Practices of the Consumer Credit Industry in Soliciting and Extending Credit and their Effects on}
companies of all types began to increasingly provide financial services. As a result, the reality for bankers is that the retail industry is emerging as formidable competitors in key areas of financial services, including how money is lent, transmitted, and handled. Further, many retail companies are also on the cutting edge of mobile payment systems.

As with all thorny issues, there are no easy answers, but a few relevant questions to ponder. First, even bankers will agree, the “business of financial services” and “financially related” activities under the BHCA, by law, is intended to be an evolving concept. As promulgated in the GLBA, “financially related” was initially identified in 1999 as the banking, insurance, merchant banking, and securities business. The GLBA amendments to the BHC Act provide for the potential expansion and evolution regarding what constitutes “financially related” activities, and provided a broader possibility of activities that are “complementary” to financial related activities. Even without banking charters, most retail companies engage to some degree in a variety of financial activities, including lending and transactional money handling activities. Further, a number of nonfinancial companies continue to conduct banking activities through the ILC “loophole” and a laundry list of the other grandfathered legal loopholes such as unitary S&L holding companies, non-bank banks, trust banks and so-called “CEBA” banks cited in the 2012 GAO Study.

CONSUMER DEBT AND INSOLVENCY 4–6 (June 2006).

125. Id.


128. See 12 U.S.C. 1843(k) (2006) (as amended by Section 103(a) of the GLBA). The BHCA permits the FRB and Treasury to jointly agree as to what activities may be added to the list of permissible financially related activities. Id.

129. See 2012 GAO Study, supra note 87, at 48. See also FDIC Study, supra note 3. So-called “CEBA” banks are institutions chartered under the Competitive Equality Banking Act (“CEBA”) of 1987. A CEBA bank is not a “bank” for purposes of the BHC Act if it engages “only in credit card operations” and does not: (1) accept demand deposits or other
A number of commercial companies have a ready and loyal customer base to cross-sell financial products and services and want to cut costs associated with fees they currently pay to banks for credit card, check cashing, money transmission and other money handling transactions on behalf of their customers. Large retailers also may want a multistate, full-service banking operation based in their retail stores, or want to own and operate banks for purposes of limited product lines, such as auto lending. Finally, some want to access federal deposit insurance and offer their customers deposit taking services.

In light of the foregoing, one possible approach is to expand the category of, and build more flexibility into the definition of "financially related," and permit some activities of commercial firms under the BHC Act to qualify as financially related activities, with appropriate structural and prudential safeguards as the industries involved continue to evolve their business models. This approach is consistent with the history of banking regulation in expanding the scope of permissible activities of bank holding companies and their affiliates while giving due regard to prudential safeguards.

The recent history of permitting activities that had previously been considered "non-banking" within bank regulatory schemes arguably supports this evolutionary approach. For example, the GLBA repealed section 20 of the Banking Act of 1933 (the Glass-Steagall Act),\(^{130}\) which had previously prohibited a bank or its affiliates from engaging in the underwriting of securities.\(^{131}\) Specifically, former section 20 prohibited any bank which is a member of the Federal Reserve System (including all national banks and state-chartered member banks) from being affiliated with any entity that is "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution, at wholesale, retail, or through syndicate participation" of securities that the bank may not underwrite or deal in directly ("ineligible securities").\(^{132}\)

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Checking accounts; (2) accept savings or time deposits of less than $100,000, unless for collateral on a loan; (3) maintain more than one office that accepts deposits; or (4) engage in the business of making commercial loans.


132. See 12 U.S.C. § 377 (repealed 1999). In light of the recent financial crisis there have been some calls for reinstatement of the Glass-Steagall Act. See, e.g., Andrew Ross
In a series of actions approved between 1984 and 1997, the FRB adopted a two-pronged approach to define the scope of permissible activities for securities affiliates of member banks. First, the FRB ruled that an affiliate of a member bank would be “engaged principally” in underwriting and dealing in ineligible securities, and therefore would be in violation of the Glass-Steagall Act, if its gross revenues from such activities exceeded five percent—later increased to ten percent—of its total gross revenues. Second, the FRB imposed extensive firewalls, including rules governing exposure to individual customers, cross-marketing, fiduciary purchases of securities underwritten by a Section 20 affiliate, capital adequacy, loans to customers of a securities affiliate, board and officer interlocks, and disclosure of customer information. Securities firms whose activities satisfied these limitations and who received FRB approval to operate as an affiliate of a member bank became known as “Section 20 subsidiaries” or “Section 20 affiliates.” By 1997, the FRB had further increased the gross revenue limit to twenty-five percent. In 1999, as noted, GLBA removed all restrictions on securities underwriting, deeming such activities “financially related.” As such, over a period of years a non-banking activity specifically prohibited by federal law for bank affiliates became a specifically permitted activity.

Further, another avenue would be to consider the implications of a new class of financial company created by Dodd-Frank—any company “predominantly” engaged in activities that the FRB determines are financial in nature or incidental thereto, other than a bank holding company or nonbank financial company supervised by the FRB (Predominantly Financial Company). This category includes any subsidiary of a bank holding company or other company if the subsidiary is predominantly engaged in such activities and is not a


134. Id.
135. Id.
136. Id.
138. But see supra note 129.
depository institution or insurance company. The term “predominantly” engaged in financial activities currently means that the consolidated revenues of the company from financial activities, including revenues from owning a depository institution, constitute eighty-five percent or more of the company’s total consolidated revenues.

In addition, a “nonfinancial” company may be designated by the Financial Stability Oversight Council (FSOC) for supervision by the FRB if it engages in “some” financial activities—but not “predominantly”—and is determined by the FSOC to require supervision by the FRB. Such a company may become subject to FRB supervision if the FSOC determines that material financial distress related to its financial activities would pose a threat to the financial stability of the United States and that the company is organized or operates in such a manner as to evade Board supervision. If such a determination is made, the company may be required to transfer its financial activities to an intermediate holding company for supervisory purposes.

Under evolving regulatory standards in recent years, the purported regulatory wall separating banking and commerce is not as impenetrable as it may appear; in fact, as previously described in this article, it is actually somewhat porous and has evolved over time. As such, the foregoing discussion amply demonstrate that activities previously considered “non-banking” activities have over time become

140. Id.
141. Id. The only apparent consequence of falling into this category is that the company may become subject to an orderly liquidation process administered by the FDIC if it fails. The process is triggered if the Secretary of the Treasury, in consultation with the President of the United States, makes a determination that the company’s failure would have serious adverse effects on financial stability in the United States. See 12 U.S.C. § 5383(b) (Supp. V 2011).
143. Id.
144. The coverage of these companies under FRB supervision is mainly an “anti-evasion” measure designed to prevent nonbank financial companies from structuring their operations so as to evade FRB supervision. The FRB has stated that such evasion may occur, for example, if a large, interconnected company that is predominantly engaged in financial activities slightly alters the manner in which it conducts an activity that is financial in nature so that the activity does not comply with one of the restrictions that govern the conduct of the activity by a bank holding company for the purpose of reducing the company’s financial revenues and assets and avoiding designation by the FSOC as a nonbank financial company supervised by the FRB. See 76 Fed. Reg. 7731, 7736 (Feb. 11, 2011).
permissible "financially related" activities; nonfinancial companies engaging in financial activities may now become subject to bank holding company regulation pursuant to Dodd-Frank; and similarly, financial companies do not need to be linked solely to "financially related" activities.

Accordingly, in light of the above described recent legal and policy developments regarding the interpretation of the scope of permissible banking and "financial activities," it is no quantum leap in analysis to identify a financial company regulatory model that permits "financial holding companies," as defined under current law to engage in a specified level of "non-financial activities." The Predominantly Financial Company standards and the evolution of non-banking activities as financially related clearly mark this path. Further, it can be argued that all financial companies do engage in a level of non-financial activities that are still related to financial activities, and even if they are not, an important question is whether there is a compelling safety and soundness rationale that today's complex financial services companies must be pristinely engaged solely in financial activities.

Further, this analysis also would allow for a "commercial" company's activities to be closely analyzed to determine what components of its activities are actually financial in nature, and where a specified level of financially related activities are present, permit such companies to potentially own not just ILCs but any federally insured depository institutions. For example, major components of the business and sales activities of most, if not all, retail and commercial companies currently owning or controlling ILCs are clearly financial activities: consumer and commercial credit, debit, prepaid and gift card operations, layaway, consumer, small business and secured lending, check cashing and printing, online bill payment and account services, money order and wire transfer and tax preparation services, and even mortgage lending. It may be argued that such financial activities in most cases constitute a substantial if not predominantly component of the business operations of such companies. As such, why can't such companies be considered financial companies, i.e., Predominately

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Financial Company standards?

5. Leave oversight of small, less complex ILCs with FDIC and transfer oversight of large complex ILCs to the FRB

This is another potential option proposed by the 2012 GAO Study. On the one hand, it may satisfy the concerns of the banking industry and the FRB by leveling the regulatory playing field for holding company regulation of larger ILCs and their parent companies. However, the FRB will still likely argue its primary role is as a consolidated bank holding company supervisor, and that there is a contained, but substantial likelihood of regulatory arbitrage with more than one holding company regulator. Further, it still does not specifically address the question of how to regulate a commercial company that owns a bank. Use of the IHC and increased oversight of affiliate relationships may be productive alternatives.

V. CONCLUSION

What happens next is anyone’s guess. No party to the debate will disagree that only those companies engaging in safe and sound banking activities well-insulated from parents, affiliates, and subsidiaries should be in a position to obtain deposit insurance. Deposit insurance is ultimately backed by the U.S. taxpayer, so the deposit insurance system should always be positioned such that deposit insurance is not a “heads I win, tails you lose” proposition from a moral hazard perspective.

Both financial services companies and commercial companies engaged in—or wishing to engage in—financial activities may do well to consider the famous phrase “one day I looked at the enemy and they were us.” Legislators and regulators often are fighting the last war, so to speak, and the big question is whether there will—or should be—a reconciliation of evolving marketplace realities, competitive issues, and safety and soundness concerns in this area to mutual advantage for banking and commercial companies.

The foregoing discussion points out only a few possibilities for enhancing the competitiveness of U.S. companies engaged in financially related activities while addressing regulatory and competitiveness concerns. Ultimately, the stomach for mixing what has
been traditionally characterized as "banking" and "commerce" may depend on the regulatory climate, the interests of the ILC industry to protect its status, and the interest of the banking industry to limit competition or for that matter, pursue commercial activities.

While longstanding arguments continue to be made about the need for the separation of baking and commerce, the fact of the matter is that the marketplace—and even the banking laws in landmark reform regulation such as Dodd-Frank—show a different reality evolving where the lines between financial and commercial activities have become blurred. The lifting of the ILC moratorium provides a perfect opportunity to assess these businesses and competitive developments and further refine a regulatory approach to the continuing trend of financial and commercial activities becoming more closely related by the day.