Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate

By Kenneth Spong and Eric Robbins

Industrial loan companies, or ILCs, are a small, but rapidly growing part of the financial industry. These state-chartered institutions operate in seven states and have nearly all of the same powers as commercial banks. However, ILCs differ greatly from banks in one characteristic—the type of companies that may own them. ILCs meeting certain conditions may be owned and operated by firms engaged in commercial activities, thus skirting the prohibitions on mixing banking and commerce that apply to virtually all other depository institutions.

Commercial ownership is now a prominent topic in banking with Wal-Mart's recent attempt to open an ILC and Home Depot's efforts to acquire an existing ILC. At the center of this controversy are such questions as whether commercial firms—retailers, manufacturers, and others—should be allowed to use ILCs to get into banking and what would be the public policy implications of such entry.

Those opposing the Wal-Mart and Home Depot proposals, for instance, contend that ILCs owned by commercial entities would face significant conflicts of interest. Such ILCs, it is argued, would have strong incentives to lend to customers of the parent company on a

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favorable basis and without due regard for standards of creditworthiness. These conflicts might thus be resolved to the detriment of the ILC, its customers, or the deposit insurance system and other elements of the federal safety net. Another common argument is that Wal-Mart and others might be able to exploit their size and existing customer relationships in a manner that would give them a dominant role in banking markets, thereby reducing financial competition. To allow Congress to consider such issues, the Federal Deposit Insurance Corporation (FDIC) placed a moratorium until January 2008 on commercial firms opening or acquiring insured ILCs.[1]

While the Wal-Mart and Home Depot proposals are behind much of the ILC debate, the public policy issues are much broader than these two proposals. Financial and commercial firms have made significant inroads into the ILC industry, mostly within the last decade or so. In fact, among the most recognizable owners of ILCs are Merrill Lynch, Morgan Stanley, American Express, General Electric, General Motors, Toyota, BMW, Volkswagen, Target, and Harley-Davidson. Consequently, many of the issues surrounding broader ownership of ILCs are far from hypothetical. Considerable information already exists on how financial and commercial firms use ILCs and what are the associated issues and benefits.

This article uses this broader ownership experience with ILCs as a starting point to examine the public policy issues that arise from mixing banking and commerce. The first section reviews the history of ILCs and the basic legal and supervisory frameworks under which they operate. The second section looks at the reemergence of ILCs under their new forms of ownership. The third section focuses on the ILCs owned by financial and commercial firms, taking a close look at individual ILCs and the types of business they conduct. The fourth section explores the public policy issues.

I. HISTORY AND REGULATION OF ILCs

ILCs, also known as industrial banks, first emerged in the early 1900s to provide small loans to industrial workers. This market developed because commercial banks were generally unwilling to offer uncollateralized loans to factory workers and other wage earners with moderate incomes. Much of the early success of industrial banks can be attributed to Arthur J. Morris, who chartered the first ILC in 1910 and established the basic framework for Morris Plan banks.[2] Morris Plan banks spread to over 140 cities by the early 1930s and became the leading providers of consumer credit to lower-income workers.

Since then, commercial banks and other institutions have largely taken over the role of providing small consumer loans, thus leaving traditional ILCs with only a small segment of the consumer lending business. More recently, though, ILCs have reemerged as a way for commercial and financial firms to offer banking services without being subject to the ownership restrictions and parent company supervision that typically apply to other companies owning depository institutions. This new growth is further driven by a number of business or financial factors. For instance, ILCs enable commercial firms to offer financing to their customers, clients, or dealers, thereby supporting a company's operations. For example, auto companies and manufacturers can use ILC lending to help boost sales of cars and other products. Such firms can also use ILCs to attract new customers and retain existing ones. Furthermore, technological advances in data processing, communications, and payment systems are making it more cost effective to offer multiple services to customers, thus opening the door for commercial firms to offer financial products.

ILCs have traditionally operated under their own unique regulatory and supervisory system, but over the past few decades, this public oversight has become more like that of other depository institutions. ILCs still operate under special state charters and continue to be examined by state authorities. The handful of states that still charter ILCs, though, have gradually increased ILC powers to the point where most now operate under a legal framework similar to that of state-chartered banks.[3] ILCs, for instance, can generally engage in a full range of consumer and commercial credit operations and other standard banking activities. At the same time, some states do not allow ILCs to offer demand deposit accounts, and not all of the states chartering ILCs welcome commercial ownership. In particular, California passed a law in 2002 prohibiting commercial firms from acquiring or opening ILCs in the state. This law was adopted after Wal-Mart attempted to open an ILC there.

Federal policy with regard to ILCs primarily has been set through two pieces of legislation: the Garn-St. Germain Depository Institutions Act of 1982 and the Competitive Equality Banking Act of 1987. The Garn-St. Germain legislation made all ILCs eligible for federal deposit insurance, thus replacing the case-by-case approval process the FDIC had been using. This expanded eligibility for federal deposit insurance is also significant since it brings ILCs under the supervision of both a state authority and the FDIC.[4]

The Competitive Equality Banking Act allows a company to own an ILC without being subject to the same regulatory framework as bank holding companies. As a result, ILC owners can avoid the restrictions on conducting commercial activities that apply to banking organizations. At the same time, this legislation closed other avenues that a number of commercial firms had previously used to get into banking, thus putting ILCs in a unique position within the financial system.

Under the provisions of the Competitive Equality Banking Act, an ILC owner is excluded from activity restrictions imposed on bank holding companies as long as its ILC is located in a state that requires the institution to have FDIC insurance. In addition, the ILC must meet at least one of the following conditions: 1) The ILC does not accept demand deposits. 2) The ILC's total assets do not exceed $100 million. 3) The ILC was acquired before August 10, 1987.[5] For larger nonbanking organizations seeking to establish ILCs of more than modest size, these provisions mean that their ILCs must avoid offering demand deposits, although NOW accounts are still an option.[6]

By meeting at least one of these three conditions, an ILC and its owner can further avoid the consolidated supervision that applies to bank and thrift holding companies.[7] This ability to avoid consolidated supervision, though, does not hold true for ILC owners that also own a bank or a thrift, or are a securities firm subject to oversight by the Securities and Exchange Commission as a "consolidated supervised entity." Under consolidated supervision, holding company supervisors typically analyze the condition, risk management practices, and capital of the parent company and any significant nonbanking subsidiaries, particularly if these subsidiaries could pose a risk to the bank or thrift affiliates. By avoiding such supervision, some ILC owners thus face one less layer of regulation compared to other companies that own depository institutions.

With regard to federal regulation of individual ILCs, the extension of FDIC insurance to ILCs requires that these institutions comply with many of the same laws and examination procedures that apply to other federally insured banks and thrifts. This ILC regulatory framework includes minimum capital standards, other FDIC standards associated with safe and sound operations, consumer protection laws, and the Community Reinvestment Act.

One other set of laws—Sections 23A and 23B of the Federal Reserve Act—is of particular interest, given the relationships that might exist or develop among an ILC, its parent company, and other subsidiaries or affiliated entities. To control conflicts of interest and prevent insider abuses and misapplication of bank funds, Sections 23A and 23B limit the amount of, and the terms on, transactions that take place between an insured depository institution and any company under the same ownership.[8] For example, Section 23A generally limits the total amount of an insured bank's loans, asset purchases, investments, and certain other transactions with any one affiliate to 10 percent of the bank's capital and surplus and to 20 percent with all affiliates. These limits, though, do not apply to transactions fully secured by U.S. government obligations or a segregated, earmarked deposit account at the bank. Section 23B requires transactions with affiliates to be on terms and conditions comparable to those on transactions with unaffiliated parties. As a result of these provisions, ILCs are restricted in how much business they can conduct directly with their parent company and affiliates.

II. REEMERGENCE OF ILCs UNDER NEW OWNERSHIP

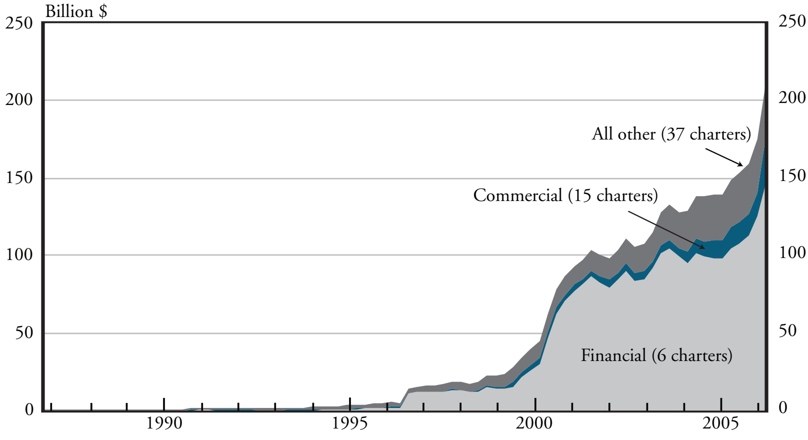
This legal framework has left ILCs as about the only option for commercial firms to enter into banking and has thus opened the door for a variety of firms to acquire ILCs. The current population of ILCs can largely be grouped into three general categories: 1) *Traditional ILCs* operate under the ownership of individuals or bank or thrift organizations. These ILCs focus on providing credit to consumers and small businesses and offer a range of deposit products. 2) ILCs owned by a *financial company*, such as a securities firm or insurance company, typically offer deposit or credit products to the parent company's clients and employees. They may also engage in specialty lending programs for institutional clients and businesses. 3) ILCs owned by a *commercial* firm generally offer a range of financial services that support the commercial operations of their parent, including credit card lending, loans to support the sale of automobiles or other parent company products, and home equity loans.

These expanded ownership opportunities have recently led to a rapid growth in ILC operations, although the industry still remains a fairly small part of the overall financial industry.[9] In January 2007, 58 insured ILCs were in operation, and 45 of these held Utah or California charters. The remaining 13 ILCs are located in either Colorado, Hawaii, Indiana, Minnesota, or Nevada. Among the 58 ILCs, 37 could be characterized as traditional, 15 are owned by commercial firms, and the remaining six are controlled by a parent already engaged in financial services.[10]

Total ILC assets have grown from about $12 billion at yearend 1995 to $213 billion at the end of 2006. Despite this rapid growth, ILCs still hold only about 1.8 percent of the assets of all insured depository institutions. Much of the growth can be attributed to the ILC activities of a handful of financial companies, which held over 69 percent of all ILC assets at yearend 2006 (Chart 1).[11] This growth has largely come from securities firms converting the cash management accounts held by their clients into insured ILC deposits, thus allowing these firms and their ILCs to take advantage of existing business relationships rather than attracting a new customer base. Commercial ownership of ILCs has also increased rapidly in recent years. But these ILCs hold just over 14 percent of all ILC assets, far less than ILCs owned by securities firms.

The five largest ILCs each hold nearly $20 billion or more in total assets. Combined, they account for 71 percent of all ILC assets (Table 1). Four are affiliated with financial services companies and the other with a commercial firm. The largest traditional ILC with independent ownership is Fremont Investment and Loan, Anaheim, California, which has nearly $13 billion in assets and engages in brokered subprime mortgage lending and commercial real estate and construction lending. At the other end of the industry, over three-fifths (35) of all ILCs operate with less than $500 million in total assets, accounting for about 3.5 percent of all ILC assets.

Chart 1
ASSETS OF 58 CURRENT FDIC-INSURED ILCs, 1986-2006



Source: Bair 2007

Table 1
TOP FIVE INDUSTRIAL LOAN CORPORATIONS BY ASSET SIZE

Institution	**Total assets (in millions)**	**Total deposits (in millions)**
Merrill Lynch Bank USA	67,235	54,805
UBS Bank USA	22,009	19,270
American Express Centurion Bank	21,097	4,446
Morgan Stanley Bank	21,020	16,555
GMAC Bank	19,937	9,910

Source: Bair 2007

III. OVERVIEW OF INDIVIDUAL ILCs

ILCs operate under a wide range of ownership structures and business strategies, particularly with the recent entry into the industry by financial and commercial firms. To provide a perspective on these operations, this section looks at the characteristics of individual ILCs, including their ownership, size, office structure, lending mix, sources of funding, and business relationships with the parent company (see appendix for a list of the ILCs discussed in this section).[12] In keeping with the current public policy debate over ILC ownership, this overview of individual ILCs focuses on those owned by large financial firms and commercial companies. While ILC ownership experience by commercial firms is the most relevant for the Wal-Mart/Home Depot debate, the ILCs owned by financial firms are also important because they now make up the vast majority of ILC assets and raise a number of public policy questions as well.[13]

ILCs owned by financial companies

Several different types of financial firms own ILCs, including securities firms, companies providing credit card services, and insurance companies. The following discussion concentrates on the largest of these, noting their similarities and differences.

Merrill Lynch Bank (MLB)—Merrill Lynch and Co., Inc., owns the largest ILC, Merrill Lynch Bank. Headquartered in Salt Lake City, Utah, MLB has more than $67 billion in total assets. It has two branches at Merrill Lynch offices—one in New Jersey and the other in New York—and a variety of investment and lending subsidiaries.

MLB offers a number of different deposit accounts, with almost all of this business generated through Merrill Lynch's securities brokerage subsidiary. Much of MLB's rapid growth, in fact, has come from sweeping balances out of cash management accounts at the brokerage subsidiary and into MLB, thereby providing brokerage customers with deposits insured up to $100,000 at rates competitive with, or even exceeding, money market mutual funds. This practice is typical of ILCs owned by securities firms. MLB offers money market deposit accounts, certificates of deposit (CDs), individual retirement accounts (IRAs), and also market participation certificates. The market participation certificates have returns that fluctuate with the stock market's performance, but the principal amount is protected. In addition, MLB has a small amount of transaction accounts. More than 96 percent of the deposits at MLB are placed in money market deposit accounts and, according to recent FDIC estimates, about 80 percent of MLB's deposits are insured.

In terms of its asset structure, MLB is similar to most large commercial banks in the portion of its assets devoted to loans, but it has less need to hold cash and maintains a larger securities portfolio. MLB holds a variety of commercial, real estate, and consumer loans, with much of this business generated through its lending subsidiaries. Commercial loans make up nearly 47 percent of the loan portfolio, and many of these loans were generated by a subsidiary which lends to midsize companies in 16 states. Real estate lending constitutes another 28 percent of MLB's loans, with some of this coming from a real estate subsidiary that does residential real estate lending throughout the nation. Another 16 percent of MLB's lending is through consumer loans. Much of MLB's remaining assets are in mortgage-backed and other asset-backed securities.

Unlike typical depository institutions that might maintain a large office network to offer retail banking services, MLB operates with extremely low salary and premises costs. As a result, the ratio of its earnings to average assets in 2006 was roughly twice the average earnings rate of commercial banks.

Other ILCs owned by securities firms—Several other ILCs are owned by large internationally active securities and investment firms. These include UBS Bank USA, Morgan Stanley Bank, Goldman Sachs Bank USA, and Lehman Brothers Commercial Bank. For the most part, they operate using a business model similar to that of Merrill Lynch Bank—sweeping funds into insured interest-bearing accounts from the cash balances their customers maintain with securities affiliates.

Another common characteristic among these ILCs is their lower operating cost relative to commercial banks. Unlike large commercial banks with their extensive retail banking networks, these ILCs each operate with just a single office in Utah. Also, they typically have a very small number of employees, instead relying on their parent company to generate and book much of the business they do. This operational structure results in high income levels for most of these ILCs, while allowing them to offer competitive rates to their customers.

Also, the ILCs owned by securities firms generally operate with a higher level of capital than do commercial banks of similar size. For example, the average equity capital ratio for commercial banks over $10 billion in assets is about 10 percent, compared with 13.4 percent for Morgan Stanley Bank, 10.6 percent for UBS Bank, 12.3 percent for Goldman Sachs Bank, 8.2 percent for Merrill Lynch Bank, and 13.8 percent for Lehman Brothers.

ILCs owned by credit card companies—Several ILCs are owned by companies that issue credit cards or provide a variety of services within the credit card industry. One of these ILCs, American Express Centurion Bank (AECB), is owned by American Express Company and operates out of its credit card processing center in Utah and an offshore funding facility in Grand Cayman. AECB has $21.1 billion in assets, most of which consist of credit card loans to individuals. Funding for these loans largely comes from other borrowed funds, brokered deposits, and foreign deposits. As a result, AECB mostly operates as a credit card bank for American Express. Its earnings are well above that of the typical bank or ILC due to high interest income from credit cards, moderate funding costs, very low salary and premises expenses, and other operating benefits provided by its parent.

Several other ILCs focus on credit card lending. Advanta Corp., which has a background in consumer credit and subprime lending, owns an ILC in Utah that provides small business credit cards on a nationwide basis. Another ILC, Merrick Bank, markets secured and unsecured credit cards on a nationwide basis and is owned by a company that offers a variety of services for issuers of credit and debit cards.

ILCs owned by insurance companies—Another group of ILCs are owned by firms conducting insurance activities and other related business.[14] USAA Savings Bank, an ILC in Nevada, has $5.8 billion in assets and provides banking services and credit cards to military personnel and their families. USAA Savings Bank is owned by United States Automobile Association—an insurance and diversified financial services organization.

Exante Bank is an ILC owned by UnitedHealth Group and is located in Utah. It offers healthcare savings accounts, healthcare account and flexible spending cards, and other healthcare payments services.

Another ILC, Fireside Bank, is owned by a broad-based insurance company and finances automobiles through the purchase of retail installment contracts from automobile dealers. 5 Star Bank has its main office at Peterson Air Force Base in Colorado Springs, Colorado, and is owned by the Armed Forces Benefit Association, which provides low-cost life insurance to military personnel. 5 Star Bank primarily serves members of the armed forces and offers a full range of deposit products, a nationwide credit card operation, and a limited amount of real estate lending. Most recently, Well Point, Inc., one of the country's largest health insurance companies, received FDIC approval on its application for an ILC charter in Utah.[15] The majority of these ILCs thus were formed to provide banking services to the parent company's insurance customers, although several serve other market niches.

ILCs owned by commercial companies

While the majority of the industry's assets are controlled by ILCs owned by financial companies, ILCs owned by commercial companies also play an important role in this industry. As noted earlier, most commercially owned ILCs focus on activities that support the commercial activities of their parent, while a few engage in broader banking services. Commercially owned ILCs fall into two categories, those owned by automotive companies and those owned by other commercial parents.

ILCs owned by automotive companies—Automotive companies have shown particular interest in ILC ownership. GMAC, Volkswagen, Toyota, BMW, and Harley-Davidson have ownership interests in ILCs, and Daimler-Chrysler has an ILC application pending with the FDIC.[16] Some of these companies use their ILC to finance automotive sales, while others offer financial products, such as credit cards and home equity loans, to owners of their automobiles or to auto dealers.

GMAC Automotive Bank (GMACB) has become the largest commercial ILC with total assets of $19.9 billion.[17] GMACB began operations in 2004 from a single office in Utah for the purpose of underwriting automobile loan and lease contracts generated by the nationwide network of independent GM dealers. Although the bank continues with this business, $13.4 billion of its $16.4 billion in total loans now consist of 1-4 family residential mortgages. Much of this real estate lending appears to have come to GMACB in late 2006 after GMAC began winding down the operations of a federal savings bank it owned. Most of the other loans at GMACB are consumer-related auto paper.

GMACB's funding is from a mixture of deposits and Federal Home Loan Bank advances. GMACB had $9.9 billion in deposits at yearend, virtually all in nontransaction accounts and more than half in brokered deposits issued in denominations of less than $100,000. To help support its new mortgage lending operations, GMACB has nearly $7.3 billion in Federal Home Loan Bank advances.

GMAC also operated a commercial mortgage business through another ILC in Utah, GMAC Commercial Mortgage Bank. In 2006, GMAC sold majority interest in this ILC to an investor group led by affiliates of Kohlberg Kravis Roberts & Co., Five Mile Capital Partners, and Goldman Sachs, while retaining a 21 percent interest for itself.[18] The ILC now operates under the name of Capmark Bank.

Other automotive companies—BMW, Volkswagen, Toyota, and Harley-Davidson—that own ILCs generally operate these institutions in a similar fashion to GMACB—underwriting loans or lease contracts for automobile purchases. BMW Bank, with assets of $2.2 billion, and Volkswagen Bank USA (VWB), with assets of $665 million, both operate out of single offices in Utah and focus primarily on financing automobile purchases for BMW and Volkswagen dealers. Each of these ILCs offers credit card loans to car owners, and VWB also does 1-4 family residential real estate lending. On the funding side, both ILCs rely on brokered deposits. As is typical for most commercially owned ILCs, VWB does not offer transaction accounts or solicit retail deposits from walk-in customers but uses brokered deposits under $100,000, large CDs, some borrowings from the parent, and substantial equity capital to fund its lending activities.

Eaglemark Savings Bank, chartered in Nevada and owned by Harley-Davidson, underwrites both motorcycle and aircraft loans to individuals and corporations. Compared with other ILCs, Eaglemark is very small, with only $25 million in assets.

Toyota Financial Savings Bank (TFSB) differs from the other ILCs owned by automobile companies in that much of its current efforts focus on providing banking products to Toyota, Lexus, and Hino (Toyota's commercial truck division) dealers. Initially, this strategy was targeted toward dealers in Nevada and California, but eventually TFSB hopes to expand nationwide. TFSB also plans to provide financial services to owners of Toyota and Lexus automobiles across the United States.

TFSB has $176 million in total assets and operates from one office in Henderson, Nevada. It now offers residential real estate loans and personal lines of credit for the parent company's dealers and, under the trade name of Lexus Financial Savings Bank, credit cards to Lexus owners. Nearly three-fourths of TFSB's loan portfolio is in real estate loans, and the remainder is in credit card and other consumer lending, thus leaving this ILC with very little auto financing business. TFSB also does not offer transactional deposit accounts, with most of its funding coming instead from other borrowings and a very high level of equity capital.

ILCs owned by other commercial companies

Most of the largest ILCs owned by commercial companies are associated with automobile manufacturers. However, several other ILCs are owned by other types of manufacturers and retail businesses. Their operations may provide a clue to what might be expected if Wal-Mart, Home Depot, or other retailers were allowed to set up their own ILCs.

GE Capital Financial (GECF) has been part of GE Capital Corporation since 1990 and operates from a single office in Utah. This ILC has total loans of $1.9 billion and only $218 million in deposits, consisting largely of brokered accounts greater than $100,000. GECF's lending portfolio is primarily commercial and industrial loans—mostly business credit cards. GECF once was active in consumer lending, but this business was transferred in 2005 to GE Money Bank, a federal savings bank now headquartered in Utah. Much of the support for GECF's operations comes from its equity capital base of nearly $1.3 billion. This reliance on capital rather than deposit funding helped GECF achieve far higher returns on assets than the typical bank.

Target Bank was chartered in September 2004 and is relatively small compared to other commercial ILCs, with just $14.2 million in total assets. Target Bank operates from a single office in Utah that is not generally accessible to the public. It primarily issues private label credit cards to businesses for use in Target stores. Since this credit card lending could be viewed as benefiting the parent company (Target Corporation), Target Bank, like some of the other ILCs, must structure these transactions in a manner that complies with the restrictions of Sections 23A and 23B of the Federal Reserve Act.[19] Target Bank does not accept retail deposits but funds its lending activities through a line of credit and from deposits from its parent company, thus helping ensure compliance with Section 23A.

This lending by Target Bank and by similar ILCs offers an insight into one of the key arguments in the debate over commercial ownership of ILCs: Are there conflicts of interest that might be detrimental to the ILC, its customers, or the federal safety net? The Utah Association of Financial Services and the California Association of Industrial Banks issued the following public comment in support of ILCs on this issue:

> Banks of this type, which originate loans to finance transactions with affiliates, secure their loans dollar for dollar by a cash deposit in the bank or U.S. government securities, or the loans are sold without recourse. These banks provide advantages mostly for retailers in terms of convenience, standardized nationwide programs, and exemption from licensing in multiple states. For reasons described above, compliance with Section 23A effectively means the banks cannot utilize deposits to fund transactions with any affiliate. Because they have no risk of loan loss, these are perhaps the safest banks that currently exist. Banks in this group include Target Bank and First Electronic Bank.[20]

There are several other ILCs under commercial ownership: Pitney Bowes Bank offers lines of credit and special-purpose credit cards to buyers of the parent company's products. EnerBank (a proposed acquisition by Home Depot) is currently owned by a utility company serving most of Michigan and offers a broad range of home improvement loans to consumers who have been directed to the ILC by their contractors. And First Electronic Bank, mentioned in the quote above, offers private label credit cards to customers of its parent, Fry's Electronics.

One other commercial ILC, Transportation Alliance Bank (TAB), is of special interest because it demonstrates the very unique role that this type of ILC can play. TAB operates out of three offices in Utah and has grown quickly to $483 million in total assets. It is owned by Flying J Inc., the largest operator of diesel-fuel truck plazas in the United States. To conveniently serve truckers and RV travelers on the road, TAB offers a range of deposit and online banking services. For instance, with the help of Wi-Fi zones and computers maintained at Flying J truck stops, travelers can pay bills, transfer funds, and take advantage of other banking services while away from home. TAB customers can also bank through telephone service centers, ATMs, and the mail. Much of TAB's lending business is through accounts receivable financing and commercial credit cards for truckers. TAB, moreover, makes its accounts receivable financing available to truckers on the road, since they can use the scanning and fax equipment at Flying J truck stops to send in copies of bills of lading. With multiple truck stops in virtually every state, Flying J and TAB are able to offer banking services on a nationwide basis, thus saving truckers and RV owners the inconvenience of looking for banks in unfamiliar cities and driving and parking their vehicles in congested areas.[21]

What does this ILC experience show us?

As can be seen from the descriptions above, ILCs owned by financial firms and commercial companies are pursuing a range of business strategies, and most have relied on the parent company and its clients and customers for much of their business. ILCs owned by financial firms have grown rapidly and now make up the vast majority of ILC business. These ILCs have benefited most directly from parent company brokerage customers converting their cash management accounts into money market deposit accounts (MMDAs) and other ILC deposit accounts. For securities brokerage customers, such deposits offer the advantage of deposit insurance and competitive returns. In fact, with the wider range of ILC lending and investment options, securities firms are likely to find it easier to offer competitive returns through an ILC rather than with their cash management accounts backed by money market mutual funds. Most of these ILCs are also using parent company connections to generate their business, thereby reducing their need to have an extensive office network or a large staff of employees.

The securities firms and insurance companies that own ILCs could have chosen instead to acquire an insured bank or thrift institution and be regulated as either financial or thrift holding companies. Their choice of ILC ownership thus would appear to indicate a preference for being regulated as an ILC and for avoiding the type of consolidated supervisory framework applied to financial or thrift holding companies. In some cases, these financial owners of ILCs may have also had some broader activities that would not have conformed to the financial or thrift holding company framework.

Much like the ILCs owned by financial firms, most commercially owned ILCs also benefit from the parent company and its customer base. In fact, parent company customers, dealers, and distributors often make up much of each commercial ILC's lending business. Because these ILCs have a ready base of credit customers and must search for ways to fund this lending, they operate in a somewhat different fashion than the ILCs owned by securities firms, which typically have a large base of deposits from customer cash management accounts and must look for places to invest these funds. Few of the ILCs owned by commercial companies have attempted to start up a traditional retail banking business, which would entail offering a broad range of lending and deposit products and establishing a network of offices to attract customers.

In terms of overall performance, the ILCs owned by financial firms and by commercial companies generally have been successful in finding a unique and specialized base of customers to serve and in developing innovative products for this targeted audience. These ILCs typically operate with capital levels at or above banking industry averages. While many of the ILCs have experienced rapid rates of growth, their parent companies and their own internal resources have continued to supply the funds necessary to keep capital in line with asset growth. Several ILCs have changed their business strategies as they found better opportunities, and in a few cases organizational or ownership changes have taken place. Most of the ILCs discussed in this section, though, have achieved fairly high earnings levels, part of which can be attributed to their limited staffing, minimal office facilities, and reliance on the parent company to generate business. Consequently, whether these earnings rates and performance records will continue is likely to depend, in large part, on the success in the main business lines of the parent companies.

IV. PUBLIC POLICY ISSUES ASSOCIATED WITH ILCs

Many of the public policy concerns now at the heart of the ILC debate have been part of a long-standing discussion in the United States over whether banking and commerce should be mixed and what role commercial firms should have in the financial sector.[22] The ILC proposals by Wal-Mart and Home Depot help provide a new focal point in this debate, although the same issues would also appear to apply to many of the ILCs already being operated by commercial and financial firms. While Wal-Mart's withdrawal of its application for deposit insurance in March 2007 may shift the policy debate somewhat, the basic issues will still be around when the FDIC moratorium on new commercial ILCs expires in January 2008.[23]

On the surface, the Wal-Mart and Home Depot proposals do not raise any new issues in the ILC debate. Wal-Mart's plan was to create an ILC to process electronic payments—debit, credit, and check images—made by Wal-Mart customers, thus allowing the ILC to capture the processing fees that had been going to other banks. Home Depot's proposal was to acquire EnerBank and continue its policy of making home improvement loans to customers who had been referred to the ILC by their contractors. Many of those opposing these two proposals argued that other steps would follow, such as Wal-Mart using an ILC charter and the company's extensive network of stores to establish a formidable retail banking operation in all its markets, or Home Depot using EnerBank's charter to directly lend to its large base of consumers and contractors. Whether any of this might occur is a matter for speculation. However, it seems likely that if no changes are made to the legal framework surrounding ILCs, other large firms may be interested in using this avenue to get into banking, and some may eventually try to pursue similar steps.

From a public policy standpoint, continued entry and growth in the ILC industry by commercial firms, and in some cases, financial firms, could raise a number of issues. These policy concerns include the effects on the safety and soundness of ILCs, conflict of interest issues, competitive consequences, and implications for the federal safety net.

Safety and soundness of ILCs

The safety and soundness of ILCs could be influenced by a variety of factors, ranging from their own regulatory structure and the manner in which they are operated to the strength and condition of the parent company. Since ILCs, by themselves, are subject to much the same set of regulations, activity restrictions, and supervisory processes as other insured depository institutions, they would appear to pose no unique regulatory concerns on their own. One operational concern, though, might be that a number of ILCs are largely reliant on the parent company for generating business, while also receiving much help in terms of office space, staff, and equipment. As a result, these ILCs and their performance are closely tied to that of their parents, thus leading to little diversification between the operations of an ILC and its parent and to potential difficulties if an ILC's operations had to be unwound from that of a parent. Since many of the current commercial parents of ILCs have a diverse range of activities and stable business operations, this dependency on the parent organization has not proven to be a problem so far.

At the parent company level, commercial organizations owning ILCs can escape the consolidated supervision placed on bank and thrift organizations and a number of securities firms. Some of those opposed to broader ownership authority for ILCs contend that this lack of consolidated oversight could create two problems. The owners might fail to maintain the resources necessary to support their ILC, and ILCs might be vulnerable to risks that develop in other parts of the organization.[24] Consequently, a number of Federal Reserve officials and legislators have suggested that ILCs and their parents are now operating with a "supervisory blind spot" and should be subject to the same type of consolidated supervision and enforcement actions that are imposed on bank and thrift holding companies.[25]

This lack of consolidated supervision has yet to lead to any notable problems. Although many of the ILCs owned by commercial and financial firms have grown rapidly, the previous section of this article showed that these ILCs have benefited from having large parent companies with the resources and market access to fund their expanding operations and to provide capital at levels often well above industry standards. However, consolidated supervision might prove to be helpful in a more stressful economic environment or if continued expansion in the ILC industry were to bring in parent companies less capable of supporting their ILCs.

One potential problem in extending consolidated supervision to large commercial ILC owners is that it might be difficult and costly to implement and, at best, might do little more than duplicate the discipline already exerted by the marketplace. Many current commercial owners of ILCs, for instance, are far larger than their ILCs and much larger than most banking organizations. This size and the nature of their commercial operations would undoubtedly pose difficulties for banking supervisors that have been trained mostly to look at financial operations.

The FDIC has taken a number of steps in its ILC examination and application processes to assess the potential risks that an owner could pose to an insured ILC and to monitor these parent company risks. Such steps thus inject some elements of consolidated supervision into ILC oversight, but they may not completely substitute for consolidated supervision or carry the same enforcement authority. To address these possible shortcomings, the legislation currently being considered in Congress to prevent new commercial ownership of ILCs would also place ILC operations under a consolidated supervisory framework.

Conflicts of interest

A second public policy issue associated with ILCs owned by commercial and financial firms is that these ILCs might be encouraged to sacrifice their own interests, while favoring those of the parent, other affiliates, or the parent's customers. As a result, ILCs could face conflicts of interest that might be resolved to their own detriment.

There are several basic examples of conflicts that might arise between an ILC and its parent, especially if the ILC is owned by a commercial or financial firm. Among the conflicts of interest most commonly cited for financial institutions and that appear relevant for ILCs are: 1) lending to an affiliate or customer of an affiliate at a favorable rate or on concessionary terms (including without due regard for creditworthiness) in order to directly help the affiliate or boost its business; 2) refusing to lend to competitors of the parent organization or its affiliates, which could harm a bank's business opportunities and reduce financial competition and economic growth; and 3) using bank resources to bail out the parent company or any affiliates if they encounter problems.[26]

While these conflicts are all conceivable, a number of factors could limit their occurrence and their overall effects. With regard to the first type of conflict, transactions favoring or benefiting affiliates, Sections 23A and 23B of the Federal Reserve Act limit an ILC's ability to use deposits to fund such transactions.[27] Although there can be difficulties in ensuring full compliance with these laws, the previous review of individual ILCs pointed out several examples where the restrictions either helped limit affiliate transactions or forced the parent company to provide the funding for such transactions, thus reducing the risk to the ILC. To further ensure compliance with these provisions, supervisors can use a range of enforcement actions to discourage any significant violations by ILC managers. In addition to regulatory restrictions on affiliate transactions, discipline from funding markets and a company's concern for its reputation will also play a role in limiting this type of conflict.

The second conflict—refusing to lend to competitors of the parent organization—also may not be a major concern in the case of ILCs owned by large commercial or financial companies. For the most part, an accessible and competitive financial marketplace now significantly limits any organization's ability to exploit this conflict and keep its competitors from finding financing elsewhere. Also, as shown in the previous section, a number of existing ILCs, particularly those owned by financial firms, appear to be lending to a wide range of customers and have sought out the best lending opportunities rather than pursuing those most closely tied to the parent's business lines. In some cases, ILCs under commercial ownership have targeted their lending toward the customers, dealers, and distributors of the parent company, with little, if any, lending going to competitors. This targeted lending, though, is unlikely to put competitors at a disadvantage. Such competitors would still have many other sources of financing, and the ILC lending may be little more than a replacement for loans previously made by captive finance companies and other subsidiaries of the parent organization.

The final conflicts concern—that ILCs would use their resources to bail out a parent—may also be controllable in most circumstances. ILC regulators can again limit transactions that would aid a parent or affiliate, and they may take other actions, such as restricting the dividends paid out by an ILC, to keep resources at the ILC level. Overall, these three conflicts facing ILCs owned by commercial and financial firms are not likely to be much different from and, in some cases, may be less than those from the mixing of banking, securities, and insurance that has occurred under the Gramm-Leach-Bliley Act of 1999.

Competitive effects

A third public policy issue—that competition would be harmed by the emergence of large, commercially owned ILCs—has yet to find much support in the recent expansion of ILCs. The description of financial and commercial ILCs in the preceding section indicates that many of these ILCs largely do what the parent company or its subsidiaries had once done through other means. In a number of instances, ILC entry by commercial or financial firms has even helped provide a new or a better way for reaching certain customers, thus increasing the competitive interplay in financial markets.

Retail banking, which may be the area of greatest concern from a competitive standpoint, has largely been unaffected by commercial ILC ownership. Few of the new ILCs appear to be competing directly for retail banking business by offering services similar to those of banks in the local market. Nor have they seemed willing to incur the cost of establishing an extensive office network and staff or to offer much in the way of transaction or payment services. At some point, a commercial firm with a convenient network of offices might choose to develop a retail ILC operation, much in the manner that many speculated Wal-Mart might want to do. While a major retailer might be able to make some inroads into banking markets and shift the competitive balance, this new entry would be more likely to increase than to decrease financial competition. Also, any ILC pursuing this strategy would have to prove itself against a variety of competing institutions, which has been an elusive task for a number of companies that have previously tried to jump into a broad range of financial services.[28]

Safety net concerns

A final public policy question is whether ILC ownership by commercial or financial firms raises safety net concerns and might lead to a further extension of the federal safety net in banking. This safety net consists of deposit insurance, the Federal Reserve System's discount window, and a number of other tools banking regulators have to protect financial markets and participants. While the primary purpose of this safety net is to prevent financial panics and protect small depositors, it also raises a number of public policy issues and questions about how far it should be extended.[29]

Federal deposit insurance, for instance, was introduced in the 1930s in an effort to restore confidence in banks, prevent future banking runs and panics, and protect depositors with modest accounts against loss. However, because insured depositors no longer have a need to be concerned about bankers taking on more risk, deposit insurance has also led to moral hazard problems and removed a key source of market discipline for banks. Other elements of the safety net have had similar effects by reducing the market pressure on bankers to maintain higher levels of liquidity, capital, and asset quality. To address such issues, supervisory authorities must monitor a bank's risk exposure and its liquidity, impose minimum capital standards, and set higher deposit insurance premiums for banks with greater perceived risks. These steps, though, are not likely to be perfect substitutes for the "lost" market incentives and may have additional regulatory costs. As a result, some have argued that parts of the safety net should be rolled back or the range of institutions covered by it should be limited.

Two safety net issues could potentially arise with ILCs owned by commercial and financial firms. First, some opponents of ILC expansion have expressed a concern that serious problems at an ILC and its parent could force supervisors to take steps to support the parent company and use the safety net and regulatory resources to protect its activities. They view this as even more likely when an ILC's operations are closely intertwined with those of the parent, as is the case for many commercial and financial ILCs.

FDIC and state ILC regulators have generally taken the position that their bank-centric supervisory approach and their ILC regulatory powers would still allow them to separate and isolate ILCs from their parents, thereby preventing the safety net from being extended beyond the ILC.[30] Some support for this comes from the actions a number of commercial companies have taken to restructure their ILC operations and, in several cases, sell their ILC interests to other companies. ILC regulators also argue that they can rely on readily available market information and their own insights to judge the condition of large parent companies and any resulting implications for supervisory action at the ILC level. While much of this may be true under normal market conditions, these approaches have yet to be tested with larger ILCs and under more disruptive circumstances.

A second and more critical safety net issue is associated with commercial and financial firms using insured deposits and their ILCs to fund activities that were previously financed through the capital markets. Securities brokerage customers that once had their idle balances placed in money market mutual funds are now putting such funds into insured ILC deposits. Similarly, commercial companies running ILCs, such as auto manufacturers and other large firms, are now using insured ILC deposits to fund loans they once made through captive nonbank subsidiaries and financed through the commercial paper market, loans from commercial banks, and longer-term debt and equity markets. As a result, substantial volumes of lending that were previously governed by market discipline are beginning to have safety net implications and are falling under supervisory oversight. The current interest by many commercial and financial firms in opening ILCs suggests that much more of this lending could eventually take place under safety net protections.

The first safety net issue—extending the safety net to protect parent companies—is largely a judgmental issue and should further be weighed against the strength and assistance that large financial and commercial firms have already provided to their ILCs. The second concern—the use of insured ILCs to fund activities that were formerly conducted in private capital markets—raises a more substantive concern about how the safety net should be used and whether it provides subsidies and improper incentives to insured institutions that should be carefully limited.

V. SUMMARY

The ILC industry has experienced rapid growth over the last decade, bringing with it a new financial framework—institutions that can conduct a nearly full range of banking services while operating under the ownership of companies engaged in commercial activities. This framework has reopened the long-standing debate over the mixing of banking and commerce in the United States—a debate that should intensify as the time—January 31, 2008—approaches for the FDIC to remove its moratorium on ILC applications by commercial firms.

Our review of the operations of ILCs owned by large financial and commercial firms shows that, in a relatively short period of time, they have been able to achieve a record of sound performance, innovative approaches, and strong parent company support. These benefits, though, must be balanced against many of the concerns commonly associated with the banking/commerce debate, most notably safety and soundness questions, conflicts of interest, and competitive effects. These issues are not much different from those posed by the mixing of banking, securities, and insurance under the Gramm-Leach-Bliley Act of 1999. Many of these concerns are also similar to what banking authorities currently face in their oversight of traditional depository institutions. The recent experience with commercial and financial ILCs indicates the current supervisory framework is capable of addressing most of the public policy questions, but other issues may require further debate. Among such issues are the role for consolidated supervision and how ILC safety and soundness might be affected if industry expansion were to bring in parent companies less capable of supporting their ILCs.

A remaining and important issue raised by the broader ownership of ILCs is how far public authorities should go in extending the federal safety net. Most activities now conducted by ILCs under the ownership of commercial and financial firms were once done outside of the banking system and funded without the benefit of federal deposit insurance. The use of insured ILCs for such activities thus expands the number of companies with access to government guarantees and puts further pressure on ILC supervisors to control the inherent risks. A continuation of recent ILC growth trends would further increase this safety net exposure. Much of this expansion, moreover, may be occurring without public debate and consensus on whether the underlying guarantees can be appropriately priced and allocated on an evenhanded basis or, alternatively, should be carefully restricted to a narrow audience.

There are no quick and easy answers to these supervisory and safety net questions, but they play an important role in the ILC debate, as well as in determining how the entire financial system should be structured and supervised. The ILCs owned by commercial and financial companies have helped to add innovation and competition to the marketplace, but many questions still remain about how the ILC industry should be structured.

APPENDIX

INDUSTRIAL LOAN COMPANIES UNDER FINANCIAL OR COMMERCIAL OWNERSHIP

(All financial data as of December 31, 2006, and in millions of $)

Year FDIC insurance was granted	Industrial loan company	Total assets	Total deposits	Home state	Parent company
1988	Merrill Lynch Bank USA	67,235	54,805	UT	Merrill Lynch
2003	UBS Bank USA	22,009	19,270	UT	UBS AG
1989	American Express Centurion Bank	21,097	4,446	UT	American Express
1990	Morgan Stanley Bank	21,020	16,555	UT	Morgan Stanley
2004	GMAC Bank	19,937	9,910	UT	Cerberus/GMAC
2004	Goldman Sachs Bank USA	12,649	11,020	UT	Goldman Sachs
1996	USAA Savings Bank	5,826	314	NV	USAA
2003	Capmark Bank	3,774	2,880	UT	Capmark Financial Group / GMAC
2005	Lehman Brothers Commercial Bank	3,225	2,634	UT	LehmanBrothers Holdings Inc.
1999	BMW Bank of North America	2,220	1,591	UT	BMW Group
1993	GE Capital Financial Inc.	1,992	218	UT	GE (General Electric)
1991	Advanta Bank Corporation	1,958	1,374	UT	Advanta
1984	Fireside Bank	1,382	1,163	CA	Unitrin, Inc.
1997	Merrick Bank	1,032	813	UT	CardWorks, LP
2002	Volkswagen Bank USA	665	488	UT	Volkswagen
1998	Pitney Bowes Bank Inc.	644	517	UT	Pitney Bowes
1998	Transportation Alliance Bank	483	407	UT	Flying J, Inc.
2003	Exante Bank	391	296	UT	UnitedHealth Group
2004	Toyota Financial Savings Bank	176	28	NV	Toyota
1985	5 Star Bank	166	131	CO	Armed Forces Benefit Association
2002	EnerBank	147	126	UT	CMS Energy
1997	Eaglemark Savings Bank	25	2	NV	Harley-Davidson
2000	First Electronic Bank	14	8	UT	Fry's Electronics
2004	Target Bank	14	8	UT	Target Corporation

ENDNOTES

[1]The House of Representatives has passed a bill that would prevent future acquisitions of ILCs by commercial firms, but the legislation has yet to receive much consideration in the Senate, thus leaving this ownership issue still open. With its plans delayed by the moratorium, Wal-Mart withdrew its ILC application for deposit insurance in March 2007.

[2]Under the lending structure for Morris Plan banks, small uncollateralized loans were extended to wage earners on the condition that these borrowers find two people of similar economic standing to be cosigners. For more on Morris Plan banks, see Phillips (2001).

[3]The seven states that still have active ILCs are California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah.

[4]Prior to 1982, the FDIC had allowed some ILCs to become federally insured, but FDIC insurance was typically limited to ILCs where state law allowed them to receive "deposits" or to use "bank" in their name. For more on FDIC insurance practices, see West (2004).

[5]12 USC 1841(c)(2)(H).

[6]A NOW (negotiable order of withdrawal) account is an interest-bearing account with which customers may write drafts against the money they have on deposit for the purpose of transferring funds to third parties. NOW accounts can be used much like demand deposit checking accounts, but depository institutions may legally (but virtually never do) require seven days written notice prior to any withdrawals. Also, NOW accounts can be issued only to individuals, nonprofit organizations, and certain governmental entities.

[7]For bank holding companies, the Federal Reserve is the consolidated supervisor, while the Office of Thrift Supervision performs this role for thrift holding companies.

[8]The provisions of Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) are extended to state-chartered, nonmember insured institutions by 12 USC 1828(j)(1) (Section 18(j)(1) of the Federal Deposit Insurance Act). Under the implementing regulations, 12 CFR 223 (Federal Reserve Regulation W), a bank's transactions with unaffiliated parties can also be treated as transactions with an affiliate if the proceeds "are used for the benefit of, or transferred to, an affiliate."

[9]Part of the data and the charts and tables in this paper are taken from Jones (2006) and Bair (2007).

[10]These ILC ownership categories reflect the classifications used by the FDIC and reported in Sheila Bair's Congressional testimony (Bair 2007). They are also reflected in the numbers presented in Chart 1.

[11]Chart 1 tracks only those ILCs that were still in existence at yearend 2006. For statistics and a chart on all ILCs over most of this period, see GAO (2005), pp. 18-21.

[12]Unless specifically noted, the information presented on individual ILCs in this section comes from a wide variety of sources, including the Reports of Condition and Income that ILCs file with regulators, ILC and parent company websites and press releases, deposit insurance applications and change in control notices filed with the FDIC, the FDIC's Community Reinvestment Act performance evaluations of individual ILCs, and various newspaper and trade publication articles.

[13]Unless otherwise noted, all figures in this section are as of December 31, 2006.

[14]Our division of ILCs into financial, commercial, and traditional does not directly correspond to that used by the FDIC in Chart 1 and in Bair (2007) and Jones (2006). We are discussing all ILCs that are owned by firms conducting insurance activities under the category of financial companies. Some of these firms may compete in very unique segments of the insurance market and also conduct commercial activities, but we are choosing to put all of them in the same category.

[15]The Utah Department of Financial Institutions has not yet approved the charter. See Adler (2007).

[16]Volvo has also owned an ILC in Utah since 2000, but has been shrinking its operations over the past few years and has reached an agreement to sell it.

[17]General Motors recently sold 51 percent ownership of General Motors Acceptance Corporation (GMAC) and its subsidiaries to an investment consortium led by Cerberus Capital Management, a private investment firm, thus giving the consortium control of GMACB. Minority members of this consortium include Citigroup, Inc.; The PNC Financial Services Group, Inc.; and Aozora Bank (a Japanese bank).

[18]For more information on this acquisition, see the press release of March 23, 2006, issued by Kohlberg Kravis Roberts & Co., and posted at *www.kkr.com/news/press_releases/2006/03-20-06.html.*

[19]See page 45 and endnote 8 for a description of these provisions.

[20]Utah Association of Financial Services and California Association of Industrial Banks (2006).

[21]This description of the services offered by Transportation Alliance Bank relies heavily on information reported in Utah Association of Financial Services and California Association of Industrial Banks (2006).

[22]For a look at this banking/commerce debate, see the following sources: Blair (2004), Corrigan (1991), Haubrich (2003), Huertas (1988), Krainer (2000), Mester (1992), Saunders (1994), Shull (1999), and Walter (2003).

[23]Articles that discuss the policy issues surrounding commercial ownership of ILCs include: Neely (2007), Schooner (2006), Wallison (2006), White (2006), and Wilmarth (2007).

[24]For a more complete discussion on this consolidated supervisory issue and the steps the FDIC has initiated to monitor parent company risk, see GAO (2005), pp. 27-65; and Bovenzi (2007).

[25]The issue of a "supervisory blind spot" and the need for consolidated supervision was discussed by Alvarez (2006), Alvarez (2007), and Greenspan (2006).

[26]Wallison (2006) uses a similar set of conflicts in discussing the Wal-Mart application and how the debate over financial conflicts of interest may have changed with the Gramm-Leach-Bliley Act of 1999 and its removal of the barriers to affiliation between banks, securities firms, and insurance companies.

[27]See page 45 and endnote 8 of this article for more detail on Sections 23A and 23B of the Federal Reserve Act.

[28]During the 1980s, for example, such companies as Sears, American Express, and Ford Motor Co. tried to diversify by establishing large financial services networks. For Sears, this meant trying to combine its Allstate insurance operations with its acquisitions of Coldwell Banker (a leader in real estate brokerage) and Dean Witter (a securities brokerage firm) and its development of the Discover credit card. American Express purchased several major securities and investment

companies, and Ford got into the savings and loan business by acquiring First Nationwide and then beginning an aggressive nationwide expansion strategy. All of these strategies eventually led to disappointing results and difficulties in merging customer bases and competing with more traditional institutions. As a result, each of these companies sold or spun off their new financial activities during the first half of the 1990s.

[29]For a discussion of the federal safety net in banking and the issues it raises, see Greenspan (2001).

[30]For a statement of this position, see the letter of August 29, 2005, by former FDIC Chairman Donald Powell in GAO (2005), pp. 92-97.

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