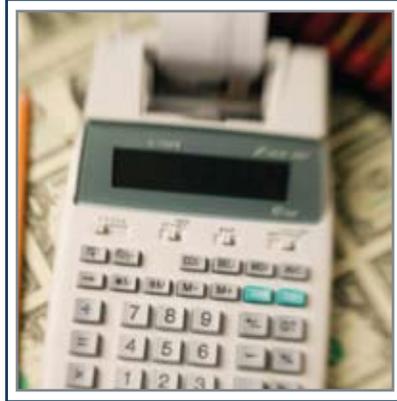


INDUSTRIAL LOAN COMPANIES

COMMERCIAL BUSINESSES FACE **HEAD-ON**
OPPOSITION TO ENTERING THE BANKING SECTOR





For Paul Keeter, the Flying J is more than just a place for his Colorado-based drivers to gas up and grab snacks for the road. The chain of truck stops is also a place—designed especially for those who live a life on the road—to do some banking when away from the home office or local branch.

About 10 years ago, Flying J opened Transportation Alliance Bank, which offers personal banking services such as checking and savings accounts, retirement and investment options, debit and credit cards, and even leasing and financing. It's the only bank that focuses solely on trucking and therefore understands the industry's needs, according to the company. Keeter's drivers are able to get pay advances while on the road through Flying J. Keeter, in turn, directly pays Transportation Alliance Bank.

Transportation Alliance Bank is not a bank in the traditional sense, but is an Industrial Loan Company, or ILC. ILCs are state-chartered institutions based in seven states around the country. A growing number operate via the Internet and other nontraditional means rather than from a brick-and-mortar storefront. ILCs have nearly all the

same powers as banks, with one big difference: They can be owned by commercial companies, such as General Electric, BMW or Toyota.

Although ILCs aren't new to the financial industry, Wal-Mart and Home Depot's recent attempts to open and acquire an ILC, respectively, are causing a stir, say Ken Spong and Eric Robbins, both policy economists at the Federal Reserve Bank of Kansas City. Spong and Robbins recently examined this blend of banking and commerce. They researched ILCs' legal framework, re-emergence, forms of ownership, business conducted and related public policy issues.

In recent years, both Fry's Electronics and Target created ILCs with hardly an eyebrow raised. But with more than 3,000 stores and supercenters and millions of financial transactions each week, Wal-Mart's massive presence crossing over into the banking sector has many critics.

In response, the Federal Deposit Insurance Corporation (FDIC) placed a moratorium on

In general, points of opposition to commercially owned ILCs include potential conflicts of interest, competitive concerns, safety and soundness issues, and implications for federal deposit insurance and similar protectors. Bankers say this type of ownership is a threat to the system should those companies or their banks fail. Advocates say ILC activities are conducted and supervised in a sound manner, and furthermore better serve niche groups.

"Our review of operations of ILCs owned by large financial and commercial firms shows a record of sound performance, innovative approaches and strong parent company support," Spong says. "But an important issue raised by the broader ownership of ILCs is how far public authorities should go in extending the federal safety net."

Background

ILCs first emerged in the early 1900s to provide small loans to industrial workers. A few decades later commercial banks and others

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commercial firms opening or acquiring ILCs. Before the moratorium ended, both Wal-Mart and Home Depot withdrew their applications. (Wal-Mart also had previously tried to buy a bank in Oklahoma and an existing ILC in California.)

The withdrawal of these two applications relieves pressure on the FDIC and Congress, which has been working to clarify ILC ownership rules as the banking industry pushes for restrictions. The U.S. Senate Banking Committee is working on a bill, but the prospects for this legislation are uncertain.

Current law leaves ILCs as the only option for commercial firms to enter into banking. Without new legislation, commercial companies, including Wal-Mart, could apply again. Both Ford and Chrysler have ILC applications pending with the FDIC.

took over, leaving ILCs a small segment of the consumer lending market.

Within the last decade or so, though, ILCs have re-emerged, allowing commercial and financial firms to offer banking services without being subject to ownership restrictions that apply to other depository institutions.

"This growth likely is driven by business and financial factors—ILCs allow commercial businesses to offer deposit services and financing to their customers, clients or dealers," Robbins says. "An auto manufacturer, for example, can use ILC lending to help support its car sales. ILCs also can attract and retain customers for the parent company."

ILCs generally are authorized to perform a full range of credit services and other standard banking activities, but not all states allow ILCs to offer demand deposit accounts, such

Industrial Loan Companies

As of early 2007, there were 58 ILCs. Forty-five have Utah or California charters; the others are located in Colorado, Hawaii, Indiana, Minnesota or Nevada.

ILCs only hold about 1.8 percent of all insured depository institutions' assets. These ILCs typically operate with capital levels at or above banking industry averages. The five largest ILCs each hold nearly \$20 billion or more in total assets and, when combined, account for about 71 percent of all ILC assets.

There are three general categories of ILCs:

Traditional: Owned by individuals, or bank or thrift organizations; focus on providing credit and deposit products. Thirty-seven ILCs have traditional ownership, the largest of which is Fremont Investment & Loan, with nearly \$13 billion in assets.

Financial services: Owned by securities firms (Morgan Stanley Bank, Goldman Sachs Bank USA), insurance companies (USAA Savings Bank) or credit card companies (American Express Centurion Bank); most offer deposit or credit products to customers of the parent company. These ILCs now make up the vast majority of ILC business. Merrill Lynch Bank, which has \$67 billion in total assets, is the largest ILC.

Commercial: Owned by businesses; most offer a range of financial services that support the parent company.

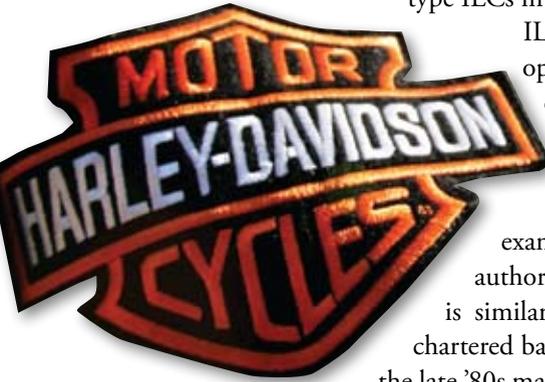
Fifteen ILCs are owned by commercial companies, many of which are automotive companies.

GMAC Automotive Bank has become the largest commercial ILC with almost \$20 billion in total assets. Much of its lending now consists of residential mortgages.

ILCs under financial or commercial ownership

ILC	Parent company
Merrill Lynch Bank USA	Merrill Lynch
UBS Bank USA	UBS AG
American Express Centurion Bank	American Express
Morgan Stanley Bank	Morgan Stanley
GMAC Bank	Cerberus/GMAC
Goldman Sachs Bank USA	Goldman Sachs
USAA Savings Bank	USAA
Capmark Bank	Capmark Financial Group/GMAC
Lehman Brothers Commercial Bank	Lehman Brothers Holdings Inc.
BMW Bank of North America	BMW Group
GE Capital Financial Inc.	GE (General Electric)
Advanta Bank Corporation	Advanta
Fireside Bank	Unitrin Inc.
Merrick Bank	CardWorks, LP
Volkswagen Bank USA	Volkswagen
Pitney Bowes Bank Inc.	Pitney Bowes
Transportation Alliance Bank	Flying J Inc.
Exante Bank	UnitedHealth
Toyota Financial Savings Bank	Toyota
5 Star Bank	Armed Forces
EnerBank	CMS Energy
Eaglemark Savings Bank	Harley-Davidson
First Electronic Bank	Fry's Electronics
Target Bank	Target Corporation

as checking or savings accounts. Nor do some states welcome commercial ownership of ILCs. California, for example, passed a law in 2002 prohibiting as much after Wal-Mart's attempt there. There are, however, many "traditional" type ILCs in California.



ILCs customarily operate under their own regulatory and supervisory system (state chartered and examined by state authorities), but oversight is similar to that of state-chartered banks. Legislation in the late '80s made all ILCs eligible for federal deposit insurance, which would require these ILCs to be supervised by the FDIC.

Under federal law, ILC owners avoid restrictions on conducting commercial activities that apply to banking organizations, as well as consolidated supervision that applies to bank and thrift holding companies. But, this law also closes other avenues some commercial

firms had used to get into banking.

"Some ILC owners face one less layer of regulation compared to other companies that own depository institutions," Robbins says. "This puts ILCs in a unique position within the financial system."

The debate

The Bollingers are probably the very type of customer Flying J had in mind when the company established its Transportation Alliance Bank a decade ago.

David and Kristal, a Kansas City-based husband and wife truck-driving team, often visit the truck stops when on the road. And now they bank there, too.

"It's easier and more convenient," Kristal says.

The young newlyweds drive together (along with pets Buddy and Tigger), alternating 10-hour shifts as they traverse from the Midwest to the East Coast,



WAL-MART'S ATTEMPTS TO CREATE A BANK OF SORTS (known as an ILC) to process its customers' electronic payments has strong opposition even though other commercial businesses have ILCs.



and sometimes into Canada. The Bollingers can be away from home for months at a time, but because their paychecks are deposited directly into their accounts with Transportation Alliance Bank, David and Kristal say accessing and managing their finances isn't a hassle while on the road. They each have a card that can be used as debit or credit, which is their primary form of payment.

It's this type of existing customer base of the parent companies that ILCs hope to also snag as banking customers. And it's this crossover that opponents say is unfair.

"If they break down the wall between banking and commerce, then we should be able to sell tomatoes," says Guy Berry, president of American Heritage Bank, a small community bank in Sapulpa, Okla.

Wal-Mart already has entered the banking industry abroad with its Banco Wal-Mart de Mexico Adelante. The corporation has nearly 1,000 supercenters, restaurants and Sam's Clubs in Mexico, and is the second chain to open banking operations there. In the United States, Wal-Mart is now leasing space to existing banks to open branches inside the stores.

In comparison, Target Bank was chartered in late 2004. With \$14.2 million in assets, it is relatively small. It operates from one office in Utah that isn't publicly accessible and primarily issues private label credit cards to business owners for use in Target stores. Target Bank doesn't accept retail deposits but funds much of its lending through a line of credit and deposits from the parent company to ensure compliance with federal banking laws.

“ If they break down the wall between banking and commerce, then we should be able to sell tomatoes. ”

Others echo Berry's sentiment, though Spong and Robbins say recent attention on ILCs doesn't raise new issues in the banking and commerce ILC debate.

"Many of the public policy concerns now at the heart of the ILC debate have been part of a long-standing discussion on whether banking and commerce should be mixed, and what role commercial firms should have in the financial sector," Robbins says.

Wal-Mart's ILC proposal was to process electronic payments (debit, credit and check images) made by its customers—not traditional bank-like services such as deposits or withdrawals. By using its own bank, Wal-Mart would have kept fractions of a cent from these transactions that would've added up to \$5 million to \$10 million a year, and meant lower prices for consumers, according to the company. Critics say this could lead to Wal-Mart using its ILC charter—and extensive network of stores—to establish retail banking operations in communities everywhere.

Opponents argue allowing this type of ownership would open the flood gates, encouraging companies to establish extensive retail banking networks, lend directly to their customer bases and upset the competitive balance in some local banking markets. Although speculative, a number of large firms are likely to have some interest in using ILCs to get into banking, but they would still have to prove themselves against a variety of competitors in retail banking markets, Robbins says.

As far as overall performance, ILCs owned by financial firms and commercial companies generally have been successful in serving specialized customer bases. High earnings levels can be in part attributed to limited staffing, minimal office facilities and reliance on the parent company to generate business.

"Consequently, whether this performance record will continue likely depends on the success of the parent companies in their main lines of business," Spong says.



BUSINESS ENTREPRENEUR PAUL KEETER works with Flying J's ILC for the benefit of his truckers, but isn't convinced any sector needs specialized banking.

Issues to consider

"The operations of ILCs currently owned by businesses may provide a clue to what might be expected if other, large retailers were allowed to set up their own ILCs," Robbins says. "Are there conflicts of interest that might be detrimental to the ILC, its customers, or safety and soundness?"

Spong and Robbins say increased entry and continued growth in the ILC industry by commercial firms raises a number of issues, including:

- **soundness:** Because commercial organizations owning ILCs can avoid the consolidated supervision placed on banks and thrifts, opponents say ILCs could be vulnerable to risks that develop in other areas of the organization. Many have said these

ILCs and their parent companies are operating with a "supervisory blind spot" and should be subject to the same supervisory framework as bank and thrift organizations, although such oversight could be costly and pose difficulties for supervisors, Spong says.

- **conflict of interest:** In a few cases, commercially and financially owned ILCs might sacrifice their own interests in favor of the parent company or its customers. Examples include lending to an affiliate or its customers at a favorable rate or without regard to creditworthiness in order to directly boost business, or refusing to lend to competitors of the parent company. However, laws, regulations and the marketplace itself can help control many possible conflicts, Robbins says.

As an example, provisions of the Federal

Reserve Act limit the amount of transactions that can take place between an ILC and its parent company, and require these transactions to have comparable terms to transactions with unrelated parties.

Because ILC loans to affiliate organizations are secured and deposits of ILC customers can't be used to fund these transactions, they are safe, says George Sutton, legal counsel for the Utah Association of Financial Services, a proponent of ILCs.

It's the regulatory efforts that ensure there is no adverse influence on the ILC from its parent company, Sutton says.

- **competitive effects:** Most commercial ILCs serve specialized customer bases and have not attempted to establish a network of retail banking offices. There is some belief, though, that competition would be harmed by the emergence of large, commercially owned ILCs, but in some instances, the entry of commercial or financial firms' ILCs has increased competition.

Berry, of American Heritage Bank, says banking and commerce should be segregated because it gives large commercial entities an unfair size and regulatory advantage over community banks.

"If an ILC comes in (communities in Oklahoma), it will wipe out hundreds of banks," Berry says, adding he doesn't think American Heritage, a \$500 million asset bank with a presence in 10 small towns statewide, would "be able to survive this onslaught. ... Some of us will make it; most of us will fail."

However, Sutton argues banks won't be displaced, but rather ILC presence would create a more diverse financial industry.

- **federal safety net:** Commercial and financial ILC ownership could lead to a further extension of the federal safety net, which includes deposit insurance, access to Federal Reserve credit and other regulatory tools. The primary purpose of this safety net is to prevent financial panics and protect small depositors. With commercial and financial

ILC ownership, funding and lending activities formerly conducted in private capital markets are being shifted into ILCs protected by the federal safety net. This raises the question of how far that safety net should be extended, and how it should be most fairly used, Spong says.

"There are no quick and easy answers to these supervisory and safety net questions," Robbins says, "but they play a role in determining how the entire financial system should be structured and supervised."

Spong adds, "The ILCs owned by commercial and financial companies have helped add innovation and competition to the marketplace, but many questions still remain about how the ILC industry should be structured."

Although Paul Keeter spent nearly two decades in the cab of his big rig and for the past 13 years has run the carrier service Keeter Enterprises LLC, he's not convinced any sector necessarily needs specialized banking—just good customer service.

Keeter works with Transportation Alliance Bank to accommodate some of his truck drivers who use those services, but does the majority of his own banking with a small financial institution that has a local branch in Boulder.

It's not affiliated specifically with trucking, but "they're interested in our business," Keeter says.



BY BRYE STEEVES, SENIOR WRITER

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By Kenneth Spong and Eric Robbins
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