

## BANKING

### Case Study: Wal-Mart applies for a bank charter

#### What is an ILB?

ILBs are chartered by state governments under state law and are subsequently supervised by state bank authorities. Some of them issue deposits that are federally insured by the Federal Deposit Insurance Corporation (FDIC). Those that receive federal deposit insurance are also regulated at the federal level by the FDIC.

Nearly all ILBs are owned by a holding company and thus are not stand-alone banks. Stand-alone banks are independent, unaffiliated with other financial institutions, and owned outright by a company that owns just the bank. In contrast, nearly all are owned through a holding company structure. These holding companies are often a major commercial or industrial company such as Toyota or BMW, or a major financial institution such as American Express or Citigroup.

An ILB can serve any client, individual or business entity, and can offer most of the array of financial products available from normal commercial banks. These similar services include:

- Credit cards
- Consumer loans including those for vehicles, RVs, and home improvements
- Loans secured by brokerage accounts
- Commercial lending
- Real estate construction
- Equipment financing and leasing
- Subprime lending
- ILBs with less than \$100 million in assets can issue demand deposits, while other can offer checkable “NOW” accounts
- Access to the Fed wire, automated clearing house (ACH) and check clearing services of the Federal Reserve

#### What public interest issues are raised?

- Conflict of interest between commercial/industrial and bank institution. The public interest concern is that a commercial entity will drain capital from financial institution, or otherwise distort the prudential investment decisions of the financial institution. [Note that two ILB failures due to mismanagement from pressure from commercial owners.]

- exposing it to a variety of risks
- trouble at parent or affiliate can severely impair the ability of an ILB to raise capital, acquire credit or otherwise gain access to other services in the financial sector

- lead to inappropriate inter-company transactions, such as drain bank of capital or profits, through
  - paying excess dividends
  - charging above market prices or interest rates
  - paying below market prices or interest rates
  - increasing lending
  - Raising reputational risks
  - exposing it to operations risk from information technology services shared with parent or affiliate
- BIF: expose bank insurance fund to greater credit risk, put otherwise, anytime there is FDIC insurance there is a public interest concern
- Competition
1. Will Wal-Mart increase competition in banking services market and result in lower priced banking services?
  2. Will Wal-Mart chase independent banks out of business and become the new local monopoly and then refuse to extend create to local retailers who compete with Wal-mart?
- Safety and Soundness concerns with commercial owned bank that lacks holding company oversight and operates with major conflicts of interest.

#### Regulatory issues

- no holding company oversight (i.e. not subject to BHCA)
- no penalties to holding company if bank fails to maintain capital or has an impairment of capital
- not subject to penalties under BHCA for unsatisfactory CRA score, and no subsequent restrictions on activities of the parent company
- FDIC regulation and oversight is limited and not yet tested regarding supervision of ILBs (according to GAO)
- create or expand loophole that leads to uneven playing field. Federal Reserve Board's long-time staffers and now newest board member put it very well in a recent interview.
 

*"Industrial loan companies are a loophole that would be greatly expanded by this legislation," Federal Reserve Board governor Donald L. Kohn said in a recent interview. "If they want parity with banks, they should have parity in every respect, and that means their parent companies would be subject to the same rules and regulations the parents of other federally insured banks are subject to. If they were granted the powers they are trying to obtain, they would be treated differently and preferentially relative to other federally insured banks."*
- Exemptions under the Competitive Equality Banking Act of 1987 (CEBA) to the Bank Holding Company Act.
  1. No federal oversight of parent company as a bank holding company. Thus ILBs are not subject to penalties imposed on a financial holding company if a subsidiary bank has an impairment of capital.
  2. ILBs are not subject to penalties under the BHCA for receiving less than a satisfactory score under the Community Reinvestment Act (CRA) rating. If an Industrial bank had to face any kind of CRA problems, it would not result in any legal restrictions on operations of the holding company or affiliates.

In a recent report to Congress, the GAO concluded that, “Therefore, from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company. For example, FDIC’s authority to examine ILC affiliates and take certain enforcement actions against them is more limited than a consolidated supervisor. While FDIC asserted that its authority may achieve many of the same results as consolidated supervision, and that its supervisory model has mitigated losses to the bank insurance fund in some instances, FDIC’s authority is limited to a particular set of circumstances and may not be used at all times. Further, FDIC’s authority has not been tested by a large ILC parent during times of economic stress.”

## **How Are ILBs currently regulated?**

### **STATE LAW**

ILBs are state chartered financial institutions that are subject to state laws and supervised by the banking authority of their home state. State charters for ILBs are not very limiting as to the type of activities undertaken by ILBs.<sup>1</sup>[15] A recent GAO report put it clearly and succinctly, “Banking laws in California, Nevada, and Utah have undergone changes that generally place ILCs on par with traditional banks. Thus, like other FDIC-insured depository institutions, ILCs may offer a full range of loans... [and] may “export” their home-state’s interest rates to customers residing elsewhere.”<sup>2</sup>[16]

Although ILBs can engage in a similar range of financial activities, these state chartered financial institutions face some differences from state to state. For example, California and Colorado prohibit non-financial firms, such as General Motors or Wal-Mart, from owning ILBs. Also, California law prohibits ILBs from accepting checking or demand deposits. Some states require ILBs to obtain deposit insurance from the FDIC as a condition for issuing deposits.

Despite being state-chartered, ILBs are allowed to “export” their home state’s interest rates for transactions in other states. This allows an ILB to charge the up to the maximum interest rate allowed by the state in which it is chartered irrespective of which state the customer is located. This means that any interest rate ceiling in the chartered-state applies for transactions nationwide. Neither Utah nor Nevada – which together make up 89% of all ILB assets – place a cap on interest rates, and so the ILBs located in those states face no anti-usury limits on the interest rates they charge borrowers.

The variation in law from state to state can lead to a lowering of prudential regulatory standards. According to David Poulsen, President of the American Express Centurion Bank, ILBs grew in popularity in specific states partially because of the states’ “low cost of operation, simple and clear consumer credit code, and generally business friendly state legislature.”<sup>3</sup>[17] A story in *Credit Card Management Magazine* expressed this more precisely, “In the days immediately preceding the enactment of CEBA [Competitive Equality Banking Act of 1987], when it became apparent that ILBs were to be preserved as a vehicle for non-bank owners, several well-known financial-services companies feverishly sought out the available ILC charters

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in Utah. The California and Colorado ILC do not appear as attractive as those in Utah. That is because Utah has fewer restrictions to impede the growth and potential usefulness of ILBs as vehicles with which to conduct nationwide lending and deposit taking.”<sup>4</sup>[18]

Hence the uneven distribution of ILBs across the country. Today, 82% of FDIC insured ILB assets are in Utah, 10% in California, 7% in Nevada and the remaining 1% in Colorado, Hawaii and Minnesota.<sup>5</sup>[19]

## **FEDERAL LAW**

Federal banking laws address ILB regulation in three major ways. First, federal law treats ILBs in much the same way as banks and thrifts. If ILBs issue deposits guaranteed by the Federal Deposit Insurance Corporation, they are then subject to supervision by the FDIC and are generally covered by the federal banking laws governing depository institutions. Federal law allows ILBs to engage in nearly all types of financial transactions as state and federally chartered banks and thrifts. One exception is their ability to offer normal checking or demand accounts. Federal restricts their ability to do so if they want to remain exempt from the Bank Holding Company Act (see discussion below). Nonetheless, ILBs can and do offer similar “NOW” checking accounts – these Negotiable Order Withdrawal accounts give the financial institution the right to delay the payment of funds for seven days, but in practice, they are usually made on demand.

The FDIC began insuring the deposits of a few ILBs as early as 1958, although it did not become general policy until passage of the Garn-St.Germain Act, P.L. 97-320 (Depository Institutions Act) in 1982. This act authorized federal deposit insurance for thrift certificates, a funding source used by industrial loan banks.

Under federal banking law, ILBs are subject to the same safety and soundness regulations and consumer protection laws. These include restrictions on transactions between the ILB and its affiliates – in general requiring them to be conducted at “arms-length.” Specifically, the law limits loans or “covered transactions” to any one affiliate to 10% of the bank’s capital and to 20% of its capital for the combined amount of loans to all affiliates. The term “covered transaction” means loans plus securities, letters of credit, credit guarantees and other such obligations from the affiliate. Federal law also requires that those transactions be conducted on ‘normal or usual’ terms, that advertising not imply that the depository institution is responsible for obligations of its affiliates, and imposes limitations on securities transactions between affiliates.

Federal banking law addresses ILBs in a second way by providing a unique exemption from the prohibition of non-financial holding companies owning a depository institution and in the subsequent exemption of those holding companies from consolidated holding company supervision and regulation.

ILBs charters allow commercial and industrial firms, such as Sears, GM or Wal-Mart, to own an ILB even though federal bank law would otherwise prohibit such firms from owning and

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operating a normal state or federally chartered bank or thrift.<sup>6</sup>[20] It is important to note that Gramm-Leach-Bliley eliminated a similar loophole for “unitary thrifts” in 1999. Today the only two loopholes by which a non-financial commercial company can own a financial institution is to obtain an ILC or a limited ‘credit card only’ bank. In this way Gramm-Leach-Bliley – contrary to some perceptions – actually strengthened the Glass-Steagall principal of separating the ownership of banking institutions from commercial and industrial enterprises.

Combining banking and commercial firms creates several types of dangers. It creates conflicts of interest that reduce the safety and soundness of the financial system, and potentially increases the market power of large conglomerate corporate goliaths. The implications for these conflicts of interest is for transfers of risk and returns between an ILB and their parent (or with its other affiliates) to result in imprudent risk-taking, distortion of public financial reporting, inefficient allocation of resources or unfair competitive advantages for firms benefiting from this regulatory loophole.

One particular concern that is raised by the Wal-Mart application is the potential for the Wal-Mart bank to drive many independent banks and thrifts out of business and thus leave many small towns and cities with only a Wal-Mart branch bank. Whereas the independent banks and thrifts made their business by lending to all sorts of businesses, their displacement by a Wal-Mart bank might result in a loss of credit and other financial services to local businesses that compete with Wal-Mart. This non-competitive behavior would lead to greater economic inefficiencies.

Although ILBs are regulated by the FDIC, their parent companies are not subject to consolidated federal oversight as bank holding companies under the Bank Holding Company Act (BHCA). The BHCA includes activity restrictions and supervisory provisions that apply to bank holding companies, i.e. any company that controls a “bank”. As a general matter, the Act defines “bank” as a financial institution that issues checkable (demand) deposits insured by the FDIC and makes commercial loans. Consolidated bank or financial holding company regulation and supervision is carried out by the Federal Reserve Board and the Securities and Exchange Commission, respectively.

The Competitive Equality Banking Act of 1987<sup>7</sup>[21] (CEBA) amended the BHCA so as to provide exemptions, under certain conditions, for ILB holding companies to avoid consolidated holding company regulation and supervision. The conditions for obtaining exemption from the BHCA are the following:

- the ILB does not accept demand deposits (withdrawals by checks payable to a third party, i.e. normal checking accounts)
- total assets of the ILB are less than \$100 million
- the ILB was not acquired after August 10, 1987

As a result of this exemption, ILBs, as well as their parent holding company, are not subject to the same capital requirements as other banks and thrifts. According to the Congressional Research Service, “ILCs and, especially their parent owners, need not always carry as much capital as banks and their holding companies.”<sup>8</sup>[22]

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The FDIC does have authority to examine any affiliate, including a parent company, of a regulated financial institution for the purpose of fully disclosing the relationship with the ILB. In contrast, a consolidated bank holding company regulator, i.e. the Fed or SEC, has the power to examine the holding company and any subsidiary even though they may not have any relationship to the insured ILB. However the FDIC does not have the enforcement authority to exercise these responsibilities in all circumstances. A recent GAO report states that, “questions remain about whether FDIC’s supervisory approach and authority over BHC Act-exempt holding companies and their non-bank subsidiaries address all risks to the ILC from these entities.”<sup>9</sup>[23]

The BHCA, as amended by the Gramm-Leach-Bliley Act, requires a bank holding company that seeks to become a financial holding company, or a financial holding company seeking to expand its activities, to maintain all its depository institutions as “well capitalized” and well managed. In contrast, FDIC enforcement action begins only after a bank fails to be “adequately capitalized.”

The FDIC claims that it can enhance its authority by threatening to withdraw deposit insurance. However this is a dangerously destabilizing ploy for dealing with a troubled financial institution. It is akin to enforcing fire safety standards on a landlord by cutting off water to the building.

As to why the CEBA carved out this exemption for ILBs while closing the loophole for near-bank banks, former Federal Reserve Board Chair Alan Greenspan wrote in a letter to Congressman Jim Leach on January 20, 2006 that when CEBA was passed in 1987 the number of ILBs was small, their total assets were small (the largest had assets of less than \$400 million) and that many states – including Utah – were either not chartering or had a moratorium on the chartering of ILBs. Greenspan went on to point out that actual market conditions have changed considerably since that time.

The third issue for ILBs and federal banking law concerns ongoing Congressional efforts to expand ILB powers. One of these would allow ILBs to offer interest bearing demand deposits, and another would allow the offering of interest bearing business NOW accounts to corporate clients. If allowed to do so, ILBs could greatly expand their deposit base. Another of these provisions would expand powers of ILBs to branch interstate – even if this would involve the creation of new branches – called *de novo* branching – and even if the branching extended into states that otherwise passed laws prohibiting such *de novo* branching.<sup>10</sup>[24] Allowing unrestricted interstate expansion through *de novo* branching would greatly increase the size of ILBs and the demand for ILB charters.

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