Tangled Up in Technicalities – An Historical Perspective on the Current ILC Debate

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1. INTRODUCTION

On Jan. 15, 2021, Rakuten, the large Japanese e-commerce and financial technology company, reapplied for federal deposit insurance for an industrial loan company it is seeking to establish in Utah. Rakuten is the first Big Tech company seeking to establish a commercial bank in the United States, despite the separation between banking and commerce that has long been a governing principle of our banking system.[1] The application from Rakuten and related, recent developments have rekindled concern about acquisitions of ILCs by commercial firms.

ILCs, also known as industrial banks, are a type of state-chartered depository institution. ILCs benefit from all of the privileges of being an insured commercial bank including deposit insurance, access to the discount window and the payments system. However, ILCs are exempt from the definition of "bank" under the Bank Holding Company Act of 1956 and as a result their affiliates and corporate parents are all exempt from the federal supervisory and regulatory framework that would ordinarily apply. Historically, Utah is the home state of choice for most ILCs – not coincidentally, as the special exemption for ILCs was crafted by a senator from Utah, who also happened to be the Chairman of the Senate Banking Committee and was able to insert the language into the Competitive Equality Banking Act of 1987 (CEBA).[2]

The BHC Act provides a comprehensive framework to regulate companies that control an insured bank and is intended to protect the safety and soundness of banks that have access to the federal safety net and preserve the separation between banking and commerce. Thus, the ILC exemption effectively serves as a loophole through which commercial firms can own insured banks, but not be subject to the federally mandated regulatory and supervisory framework intended to promote a safe, sound and stable U.S. banking system. The loophole also violates the general U.S. policy that banking and commerce should remain separate.

This note offers an historical perspective that suggests that debate over the ILC loophole is essentially a red herring—a distraction from broader questions around continuing the separation between banking and commerce. The ILC exemption was not intended to provide an avenue for commercial or retail firms (like a Walmart) to enter into banking, and there has been a long-running consensus on the need to close it. The question of the loophole simply ought to be put to rest by eliminating the BHC Act exemption for new ILCs going forward.

The traditional reason for a commercial firm to obtain an ILC charter was to provide convenient or low-cost loans to its customers or employees. Today, the applications for acquiring or establishing an ILC are coming from FinTech companies and commercial firms hoping to leverage the charter for access to the Federal Reserve payment system and to customer deposit account transactions data.

2. BACKGROUND

The original ILCs were small loan companies providing credit to industrial workers in the early 1900s, and it was not until 1982 that they generally became eligible for deposit insurance. ILCs are subject to only a single restriction on the banking products and services they can offer—a prohibition on accepting demand deposits.[3]

CEBA in 1987 addressed the major, existing loophole by which commercial firms had been evading the BHC Act prohibition on ownership of banks, whereby they could own a bank that did not offer both loans and demand deposit accounts. Although it almost fully closed this so-called nonbank bank loophole, CEBA left in place an exemption by which commercial firms could own ILCs.

The first post-CEBA, commercially owned, federally insured ILC was established in 1988, and by 2005 the number of such ILCs had increased materially. In 2005 the giant retail firm Walmart filed an application with the Utah Department of Financial Institutions to charter an ILC in Utah, and simultaneously applied for federal deposit insurance with the FDIC. In 2006, another retail giant, Home Depot, submitted a change-in-bank-control application to the FDIC to acquire an existing, federally insured ILC. These applications ultimately were withdrawn due to intense public and congressional opposition. At least in part because of the controversy surrounding those applications, no application for federal deposit insurance for ILCs belonging to commercial firms was approved during the entire period from 2006 through 2019.

Recent actions by the FDIC have revived concerns and debate around the ILC loophole. In March 2020, the FDIC approved applications for federal deposit insurance from the FinTech payment services provider Square and the diversified services company Nelnet, both of which were Utah ILCs.[4] On December 15, the agency issued a final rule codifying its supervisory processes and policies with respect to parent companies of ILCs.[5] The application resubmitted by Rakuten can be seen as a natural progression given these earlier events.

Relatedly, the Office of the Comptroller of the Currency has announced plans to offer a variety of different special purpose bank or bank-like charters to institutions that process payments, make loans or do both, but that do not take deposits. The OCC is also considering an application for a novel bank charter that would take *uninsured* deposits. There also are states that offer or plan to offer various kinds of nontraditional bank charters, notable among which is the special purpose depository institution charter offered in Wyoming and marketed to cryptocurrency exchange companies. These charters, which are called anything from "special" to "nontraditional" to "narrow," typically permit more limited bank powers compared to those permissible to the ILC. However, like the ILC, they are purposefully designed to avoid being considered a "bank" under the BHC Act and thereby exempt their beneficiaries from holding company supervision and regulation under the BHC Act.

The design and implementation of these special banking charters going forward, as their details are worked out, will need to balance the costs and benefits of liberalizing affiliations between commercial firms and banks. This note limits discussion to ILCs, but issues raised by the proposed OCC and state charters merit future study.

[3] ILCs with less than $100 million in assets and those acquired prior to August 10, 1987 are exempt from this restriction. ILCs are permitted to offer negotiable order of withdrawal accounts, which are functionally very similar to demand deposits.

[4] Nelnet is known primarily for origination and servicing of student loans, but also provides education technology, consumer finance, and telecommunications products and services.

[5] Acquisition of a federally-insured ILC by a nonbank financial institution or commercial firm requires regulatory approval from the Federal Deposit Insurance Corporation (FDIC).

3. THE NATION'S LONG-RUNNING COMMITMENT TO SEPARATING BANKING FROM COMMERCE

The separation of banking from commerce in the United States has been a governing principle since the nation's founding. The earliest state bank charters generally prohibited banks from engaging in activities outside the scope of traditional banking, such as trading or dealing in goods and merchandise.[6] The National Bank Act of 1864 granted to federally chartered banks powers inherent to the "business of banking" as well as "all incidental powers necessary to carry on" the business.

Although state bank charters and the National Bank Act had, from the earliest days of banking in the United States, restricted banks from engaging in commercial activity, mingling of banking and commerce remained feasible within a bank holding company structure. That is, banks could affiliate with commercial companies under common corporate ownership. With passage of the BHC Act in 1956, this ability was curtailed. Under the BHC Act, if a company owned banks, then its activities were limited to owning and operating banks and engaging in activities that were deemed "closely related" to banking. This meant they could not own companies engaged in commercial activities. Initially the restrictions applied only to companies that owned two or more banks, but that changed in 1970 when the BHC Act was amended to apply the restrictions also to companies that owned only one bank (closing the so-called unitary holding company loophole; see the Appendix for details).

Subsequently, a couple of other loopholes, including the aforementioned nonbank bank loophole, and a pathway via acquisition of a single savings and loan institution, enabled commercial firms to bypass BHC Act restrictions on banking activities. In response, policymakers moved to strengthen the separation, including via CEBA (see the Appendix.) The ILC exemption remains today as the one surviving loophole to permit commercial firms to operate full service insured commercial banks.

Economic Arguments for Separating Banking from Commerce. Historically, separation of banking from commerce has been motivated by concerns about anti-competitive effects and the concentration of economic power, such as might result from banks offering more favorable loan terms to their affiliates in order to drive out competitors.[7] In addition, affiliations between banks and commercial companies may create conflicts of interest. For example, as noted by Krainer (1998), "a troubled commercial firm might have an incentive to shift bad assets to its banking affiliate (and exercise the deposit insurance option); or, a bank, in order to preserve its reputation, might have an incentive to bail out a struggling affiliate."

These concerns are exacerbated by considerations that, through affiliation with a bank, a commercial firm could indirectly gain access to the federal "safety net," which includes deposit insurance and access to discount window borrowing. One such concern is that financial difficulties at a parent or affiliate of an ILC might compel bank supervisors to use safety net and regulatory resources to support the parent or affiliate, in order to prevent the difficulties from spilling over into the ILC endangering its survival. For instance, if the ILC has material exposure to uninsured depositors, troubles at the nonbank affiliate could cause the depositors to worry about the safety of their deposits, leading to a run on their deposits; that is, to withdrawals that leave the ILC without adequate funding or liquidity.

Blair (2004) suggests that the firewall restrictions contained in Section 23A and Section 23B of the Federal Reserve Act placing restrictions on transactions between an insured bank and its nonbank affiliates or its parent mitigate such concerns. Section 23A subjects these transactions to specific quantitative and qualitative limits and Section

[6] See Shull (1999) for a fuller historical discussion of the separation of banking and commerce in the U.S.
[7] This subsection draws from discussions on the separation of banking and commerce in Krainer (1998), Blair (2004), and Spong and Robbins (2007).

23B requires that they be conducted on an arms-length basis and on market terms. Indeed, these requirements are intended to guard against loss shifting and exploitation of the federal safety net.

Others argue, however, that existing firewall restrictions governing bank holding companies have not been consistently effective.[8] Moreover, enforcing these firewalls, or mitigating the potential systemic risks arising from combinations of banking with commercial firms more generally, could require a costly expansion of the banking supervisory framework. As emphasized by Saunders and Walter (2017), functional separation such as between banking and commerce is justified when the supervisory resources required to monitor and regulate financial stability become too large.

There might also be benefits to allowing banks to combine with commercial companies, such as operational synergies. In some cases, a parent engaged in commercial activities (and therefore whose fortunes are uncorrelated with its subsidiary bank) could serve as a source of strength to a subsidiary bank. However, the tradeoff between these benefits and the aforementioned costs is difficult to quantify with precision.

Aside from the historical concerns, there are rising concerns about encroachment on customer data privacy, as today's information economy increasingly revolves around "big data" (much of which is personal in nature) and the artificial intelligence tools applied to such data. Acquisition of a bank by a commercial firm may provide the parent firm with access to customers' deposit account transactions data, and the bank with access to the parent's customer data, with privacy implications.

Such privacy concerns interact with traditional concerns regarding a level competitive playing field. That is, access to expanded customer information may confer significant competitive advantages on affiliations between commercial firms and banks, all the more so in the case of Big Tech firms (which already have huge informational advantages) acquiring banks.[9]

4. THE ILC LOOPHOLE

When CEBA was enacted in 1987, most ILCs were small, locally owned institutions that had only limited deposit-taking and lending capabilities under state law, and they comprised a tiny segment of the banking industry overall. As of the end of 1987, the average ILC asset size was less than $45 million, and Utah had only 11 total ILCs chartered, with a moratorium on any new charters.[10]

In 1988, the first post-CEBA commercially owned ILC applied for FDIC insurance, and with this precedent being set, more such applications followed. Some large financial services companies (which at the time were not subject to the Federal Reserve's consolidated supervision) such as Morgan Stanley also acquired ILCs, and the years following the passage of CEBA saw rapid growth in the number and size of ILCs overall. By the end of 2005, there were 58 ILCs with combined assets of $213 billion, of which 15 were owned by commercial firms, while six belonged to some of the largest nonbank financial services companies in the U.S.[11] As described by Alvarez (2007):

[8] For example, Omarova (2011) highlights the Federal Reserve's waivers of Section 23A during the financial crisis, arguing that they authorized "massive transfers of funds" that "purposely exposed banks to risks associated with their affiliates' nonbanking businesses" and thereby exposed the federal safety net to these risks.
[9] See Bank for International Settlements (2019) for further discussion of issues raised by entry of Big Tech firms into banking, particularly around potential anticompetitive use of data and infringement on data privacy rights of consumers.
[10] See Johnson and Kaufman (2007). Utah implemented a moratorium on new ILC charters after a number of ILCs in the state experienced significant financial difficulties, resulting in the need for $45 million of state assistance to meet depositor claims.
[11] See Bair (2007), attachments 1 and 2

> "While the largest ILC in 1987 had assets of approximately $410 million, the largest ILC today has more than $60 billion in assets and more than $51 billion in deposits, placing it among the twenty largest insured banks in the United States in terms of deposits. An additional twelve ILCs each have more than $1 billion in deposits. And, far from being locally owned and focused on small-dollar consumer loans, many ILCs today are controlled by large, internationally active companies and are used to support various aspects of these organizations' complex business plans and operations."

A key development fueling this expansion was that in 1997, Utah lifted a moratorium on new ILC charters and authorized ILCs to exercise virtually all of the powers of state-chartered commercial banks. The state also began promoting ILCs as a vehicle to acquire a federally insured bank while avoiding Federal Reserve supervision and regulation under the BHC Act, thereby exploiting the CEBA loophole.[12] Consequently, most of the ILCs owned by commercial firms were established in Utah.

Whereas traditional ILCs are comparable to community banks, those owned by commercial firms have generally offered financial services that support the commercial operation of the parent, including loans to support the sale of parent company products. ILCs owned by a financial company typically have offered deposit or credit products to the parent company's clients or engaged in specialized lending activities for institutional clients and businesses.[13]

It seems clear from the historical context that the ILC exemption was not intended to provide a loophole enabling ownership of federally insured banks by commercial firms, since Congress was intent on strengthening the policy of separating banking and commerce. In particular, Sen. Jake Garn, the original sponsor of the ILC exemption in CEBA, stated during a public hearing on the Walmart application that "it was never my intent, as author of this particular section, that any of these industrial banks be involved in commercial operations."[14]

Opposition to the Loophole. The tide began to turn in 2005 when (in July of that year) Wal-Mart Stores, the world's largest retailer, sought approval from the FDIC to establish a new ILC, Wal-Mart Bank. The application was met with widespread opposition, including from the Federal Reserve Board and many members of Congress.

Opposition to commercial ownership of ILCs further strengthened when Home Depot, the world's second largest retailer, applied to purchase an ILC in May 2006. In July 2006, the FDIC placed a moratorium on processing of applications for deposit insurance for ILCs, which it later extended through Jan. 31, 2008 in reference to applications filed by commercial firms.

In extending the moratorium, FDIC Chair Sheila Bair expressed support for "statutory guidance on the key issues regarding the ILC charter, especially the issue of commercial ownership."[15] Prior to the expiration of the FDIC moratorium, Wal-Mart Stores and Home Depot withdrew their applications.

Federal Reserve General Counsel Scott Alvarez succinctly expressed the core concern raised by these applications as follows:[16]

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12 See Alvarez (2007)

13 See Spong and Robbins (2007)

14 See Wilmarth (2020), page 4.

15 See Bair (2007).

16 See Alvarez (2007).

> "The question of whether to allow firms engaged in commercial activities to own or acquire an insured ILC is one that has potentially far-reaching implications for the structure and soundness of the American economy and financial system. We believe it is a decision that should be made deliberately by Congress after hearings, debate, and careful review of the potential benefits and costs to the taxpayer and the economy. This is not a policy that should be established by exploitation of a loophole that was intended for a few small, special purpose entities."

Post-Crisis Retrenchment. Ownership of ILCs by large financial companies not under consolidated Federal Reserve supervision evaporated in the wake of the 2008 financial crisis. Some of the ILCs owned by financial firms became defunct, in most cases along with their parents.[17] Others converted to commercial banks while their parent companies reorganized as financial holding companies and came under supervision of the Federal Reserve. For example, the largest ILC controlled by a commercial firm, GMAC Bank, became a state member bank (Ally), after its parent company (Ally Financial) was spun off from General Motors.

The Dodd Frank Act of 2010 placed another moratorium on the acquisition of ILCs by commercial firms, effective for the three-year period between July 2010 and July 2013. In 2016, the Federal Reserve Board reiterated its earlier opposition to ownership of ILCs by commercial firms in its section of the federal banking agencies' Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd Frank Act. In this report the agencies provided their assessments of risks of banking activities and affiliations. The Federal Reserve recommended that Congress prohibit ownership of ILCs by commercial firms, citing risk and policy concerns (pages 28-29 and 32-35 of the report, available here.)

5. THE FDIC'S 2020 SURPRISE

Thus, the prospect for mixing banking and commerce posed by the ILC loophole was much diminished and appeared to be in decline when in 2020 the FDIC suddenly reinvigorated it. The change of course was prompted in part by the applications for federal deposit insurance for the ILCs being established by Square and Nelnet.

The FDIC approved these applications in March 2020, a day after issuing a notice of proposed rulemaking that codifies the terms and conditions governing applications for deposit insurance from ILCs, including those owned by commercial firms.[18]

The intent of the proposed rule, as described in an FDIC press release, is to "ensure that parent companies serve as a source of strength for their industrial bank subsidiaries." Moreover, by codifying the requirements that the FDIC places on approval of federal deposit insurance for ILCs, the proposal aims to "enhance transparency and provide important protections for the Deposit Insurance Fund."

Nonetheless, the proposed rule would permit the establishment or acquisition of federally insured ILCs by commercial firms, reversing the *de facto* FDIC policy that had been in place for nearly 14 years. Moreover, the conditions set forth in the proposal fell well short of the supervisory framework applicable to bank holding companies.

[17] These include Merrill Lynch Bank, Lehman Brothers Commercial Bank, Advanta Bank Corp, Fremont Investment and Loan, and CIT Bank.
[18] Specifically, the proposed rule set the terms and conditions governing applications for federal deposit insurance for firms that are not subsidiaries of companies subject to consolidated supervision by the Federal Reserve.

As a portent to what might transpire if the FDIC rule is left to stand and Congress does not act to close the ILC loophole, Rakuten, a large Japanese e-commerce and technology company similar to Amazon in the U.S., re-applied for federal deposit insurance for its planned, Utah-based ILC in January 2021.[19] Approval of that application by the FDIC could encourage other large e-commerce and information technology firms to follow suit.

In another first, in mid-February the FinTech company Brex applied for an ILC charter.[20] The Brex application is distinctive in that it marks the first instance of a startup FinTech company seeking to become an ILC. While this case does not presently raise concerns about mingling of banking and commerce, it could portend a significant, further interest in ILC charters from a wide variety of firms.

6. CONCLUDING COMMENT: THE ILC QUESTION IS A DISTRACTION FROM THE CORE ISSUES

As this historical narrative demonstrates, there has been a longstanding and firm commitment to the separation of banking and commerce in the United States. Although there have been multiple episodes where commercial firms have proceeded to exploit loopholes in the legal barriers and sought to acquire commercial banks, Congress consistently has moved to close these loopholes.

A surviving loophole is the ILC exemption from the definition of a bank for purposes of the BHC Act. Clearly, it was not originally intended to serve as a means for commercial companies to acquire commercial banks, and previous attempts by the nation's largest retailers, Wal-Mart and Home Depot, to acquire ILCs, were met with widespread opposition and eventually were withdrawn.

In the wake of the recent rulemaking by the FDIC and the agency's approval of applications from Square and Nelnet for federal deposit insurance for their ILCs, the ILC loophole threatens to undermine the separation of banking from commerce in the United States. Indeed, it enables commercial or other nonbanking firms to avoid the regulatory and supervisory framework established by Congress to promote a safe and sound banking system and preserve financial stability.

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[19] Rakuten had originally applied for a Utah ILC charter for its Rakuten Bank subsidiary in July 2019, concurrently applying for federal deposit insurance for its planned ILC. The charter application remains pending with the Utah Department of Financial Institutions. Rakuten withdrew its initial application for deposit insurance in March 2020 in the wake of the FDIC's notice of proposed rulemaking, reapplied in June, and then withdrew again in July. BPI and the American Bankers Association submitted a comment letter to the FDIC expressing opposition to the June application on the grounds that it "presents substantial concerns regarding the affiliation of banking and non-financial businesses, the separation of which is a core principle in the structure of financial services regulation in the United States."

[20] To date, Brex has relied solely on bank partners in offering a range of banking services including cash management, federally insured deposits, and company credit cards.

Appendix: Historical BHC Act Loopholes Now Closed

The One-Bank Holding Company Loophole. The original BHC Act contained a loophole whereby a bank could avoid its restrictions on nonbank activities by reorganizing into a one-bank holding company structure and obtaining OCC approval to affiliate with a nonbanking firm under the holding company umbrella.[21] This loophole was increasingly utilized, until amendments to the BHC Act enacted in 1970 closed it, by requiring the Federal Reserve to decide permissible activities based on a net public benefits test (Shull 1990).[22]

The "Nonbank Bank" Loophole. The 1970 amendments, while intended to strengthen the barrier between banking and commerce, inadvertently opened up a new loophole by redefining a "bank" to be an institution that both accepts demand deposits and engages in commercial lending. The new statutory definition enabled nonbanking firms to engage in banking activities by acquiring so-called "nonbank banks": entities that had access to federal deposit insurance but either steered clear of commercial lending or did not offer checking accounts.[23]

Nonbank banks proliferated after 1980, posing a significant threat to the separation of banking and commerce. Congress therefore moved to outlaw such entities with the Competitive Equality Banking Act of 1987 (CEBA). The nonbank bank loophole was eliminated by defining all federally insured depository institutions, with a few exceptions, to be banks, while grandfathering the existing nonbank banks and restricting their expansion. The categories exempted from this new definition were ILCs, thrifts, credit unions, credit card banks and limited purpose trust companies.[24]

The Unitary Thrift Loophole. Although the BHC Act and subsequent amendments prohibited the ownership of banks by commercial firms, the latter continued to have the option of acquiring a single, federally insured savings and loan company. This so-called unitary thrift loophole was eliminated by Congress in 1999 with the Graham-Leach-Bliley Act. With this action, "Congress reaffirmed its desire to maintain the general separation of banking and commerce" (Alvarez 2020).[25]

[21] OCC could grant approval under the "incidental powers" clause of the National Bank Act.
[22] Specifically, the 1970 amendments to the BHC Act restricted activities conducted through affiliates to those "that are so closely related to banking or managing or controlling banks as to be a proper incident thereto."
[23] The BHC Act had defined a "bank" as "any national banking association or any state bank, savings bank or trust company." This definition was revised by Congress in 1966 to cover only insured depository institutions and those that accept demand deposits and make commercial loans.
[24] See Omarova and Tahyar (2012) for more detailed discussion of nonbank banks and CEBA.
[25] Alvarez (2020) further points out that "at the same time and after lengthy debate, Congress decided to allow financial holding companies to engage in only those activities determined to be financial in nature or incidental or complementary to financial activities. In fact, in passing the GLB Act, Congress rejected earlier proposals that would have allowed financial holding companies to engage generally in a 'basket' of commercial activities or that would have allowed commercial firms to acquire a small bank without becoming subject to the BHC Act."

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