Submitted Statement for the Record of Greg Baer,
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House Committee on Financial Services

Subcommittee on Consumer Protection and Financial Institutions Hearing:
"Banking Innovation or Regulatory Evasion? Exploring Trends in Financial Institution Charters"

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The Bank Policy Institute is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

Banks operating in the U.S. are restricted in their risk-taking and activities in order to ensure their safety and soundness, compliance with consumer protection laws, and financial system stability. Those restrictions include capital and liquidity requirements, resolution requirements, and an extraordinarily intensive examination regime that oversees every aspect of their operations, often by multiple regulators. Banks practice financial innovation within this highly regulated framework.

Banks historically have also been prohibited in engaging in non-financial activities in what is known as the separation of banking and commerce. Bank holding companies may engage only in activities that are financial in nature or incidental or complementary to such activities – a list of activities that has not been meaningfully expanded over the past twenty years.

In recent years, nonbank technology firms — FinTechs and Big Techs — have begun offering banking products and services without being subject to most rules applicable to banking organizations, and generally without any onsite examination to determine compliance with what regulations do apply. They have exploited gaps in regulation to avoid both the general prohibition on mixing banking and commerce and the regulatory and examination regime that comes with offering banking products.

Regulatory arbitrage generally takes one of two routes. First, because most federal banking regulation is tied to the offering of federally insured deposits, many commercial companies have sought state or newly imagined federal charters that give them all banking powers other than the power to offer such deposits – without most of the legal obligations (and some important rights) that traditionally and appropriately come with being a bank. Second, through state industrial loan company charters, they have received almost full banking powers.

The Bank Policy Institute has published a significant amount of research documenting problems with the ersatz state charters and reimagined OCC charters, but the focus of this statement is the industrial loan company charter.[1]

BACKGROUND ON ILCS

ILCs were first established in the early 1900s to make small loans to industrial workers. Until 1987, most ILCs were small, locally owned institutions that had only limited deposit-taking and lending powers under state law. At the end of 1987, the largest ILC had assets of only approximately $410 million, and the average asset size of all ILCs was less than $45 million. The relevant states also were not actively chartering new ILCs; Utah (the state

[1] *See* BPI's Resource Site, "Keep Banking Safe" available at www.KeepBankingSafe.com.

traditionally most invested in the ILC charter) had only 11 state-chartered ILCs, and had a moratorium on the chartering of new ILCs. Moreover, interstate banking restrictions and technological limitations made it difficult for institutions chartered in a grandfathered state to operate a retail banking business regionally or nationally.

The ILC industry changed dramatically in 1987 with adoption of the Competitive Equality in Banking Act (CEBA), which required an ILC to either engage only in activities in which it engaged as of March 5, 1987 or be chartered in a state that required ILCs to be FDIC-insured as of March 5, 1987 and to meet certain criteria in order to be eligible for the exemption.[2] In 1997, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves banks and authorized ILCs to exercise virtually all of the powers of state-chartered commercial banks.[3] Since that time, Utah also has begun to charter new ILCs and to promote the ILC charter as a method for companies to acquire an insured depository institution while avoiding the requirements of consolidated federal examination and regulation under the Bank Holding Company Act.[4] For example, unlike a regulated bank holding company or intermediate holding company of a foreign bank, the corporate owners of an ILC are *not* subject to:

- The consolidated capital requirements established by the Federal Reserve;
- The consolidated liquidity standards established by the Federal Reserve;
- The financial holding company standards established by Congress in the Gramm-Leach-Bliley Act (GLB Act), which generally require a company to be well capitalized and well managed, and its insured depository institution subsidiaries maintain at least a "Satisfactory" rating under the Community Reinvestment Act (CRA), to engage in the wider range of financial activities authorized by the GLB Act; or
- Regular examination by a Federal banking agency to ensure the company complies with the Interagency Guidelines Establishing Information Security Standards (see 12 C.F.R. Part 225, App. F).

Indeed, even if an ILC was to grow to have assets of more than $250 billion, the corporate parent would avoid the enhanced capital, liquidity and other prudential standards (such as stress testing) that Congress required in the Dodd-Frank Wall Street Reform and Consumer Protection Act for the largest U.S. banking organizations.

In addition, changes in both federal law and technology now allow an FDIC-insured ILC chartered in a grandfathered state to open branches and offer its products to consumers and businesses throughout the country.

THE NEED FOR CONGRESSIONAL ACTION

Policymakers should close the regulatory gap opened by the ILC charter before it is fully exploited by the nation's largest companies in a way its drafters never imagined. 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 (R-UT), the original sponsor of the ILC exemption in CEBA, stated during a public hearing on the Walmart ILC application that "it was never my intent, as author of this particular section, that any of these industrial banks be involved in commercial operations."

ILCs introduce unique risks to the banking system and the Deposit Insurance Fund because their parent companies are exempt from the BHCA and thus can avoid the same consolidated federal supervision and regulation framework or activity restrictions as bank holding companies, even though ILCs offer banking products and services that are functionally indistinguishable from those offered by commercial banks.
Furthermore, Big Tech ownership of ILCs presents an additional set of concerns about the protection of consumer data, including sensitive personal financial information. This is a critical consideration due to the gaps created

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[2] Where permitted by state law, an ILC may offer demand deposits if the ILCs assets are less than $100 million or if the ILC has not been acquired after Aug. 10, 1987. ILCs with less than $100 million in assets and those acquired prior to Aug. 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.
[3] Under Utah law, ILCs are generally authorized to make consumer and commercial loans and to accept federally insured deposits, but not demand deposits if they have total assets greater than $100 million.
[4] https://dfi.utah.gov/financial-institutions/industrial-banks/.

when ILC parent companies are not subject to the same information security and financial privacy requirements as parent companies of commercial banks. An ILC parent company would have limited restrictions on the use of consumer financial data for commercial purposes, a concern heightened by Big Tech's ownership of ILCs due to the possibility of discriminatory pricing and provision of banking services based on this data. The absence of enterprise-wide privacy and information security requirements thus creates risk for ILC customers.

CONGRESS SHOULD ACT NOW TO PROTECT THE INTEGRITY OF THE FINANCIAL SYSTEM AND CONSUMERS

BPI supports Congress closing the ILC loophole while recognizing the fact that parents of ILCs that are subject to consolidated supervision by the Federal Reserve do not pose additional risks to the system and need not be included in any eventual limitation on ILC parent companies. These include both bank holding companies and foreign banking organizations with operations in the United States that are already regulated as bank holding companies under the International Banking Act. BPI also supports grandfathering existing ILCs as of March 2020.

While the FDIC recently attempted to codify more effective regulation, Congress has long since determined that the Federal Reserve is the appropriate regulator of companies that own banks, and that oversight of those companies should include capital and liquidity requirements and, for larger companies, enhanced prudential standards. The FDIC's rules, which are enforced by agreement with the agency, are no substitute. In addition, the FDIC retains the discretion to eliminate or reduce any requirements imposed by those agreements.

Moreover, Congress should act to maintain the historical separation of banking and commerce in U.S. law. Past (and potentially, future) efforts by large commercial firms, such as Walmart and Home Depot, to acquire FDIC-insured ILCs have raised significant concern, and the FDIC's proposal would not prevent such firms, or large technology companies such as Facebook or Amazon, from acquiring FDIC-insured ILCs. Indeed, Rakuten, which is widely known as the "Amazon of Japan," currently has an application pending with the FDIC to establish an FDIC-insured ILC.

BPI's members welcome competition with new entrants to the banking system provided that those new entrants are subject to the same prudential supervision framework and activity restrictions that Congress has established for the corporate owners of full-service insured banks. And consumers should not be subject to increased risk solely because their bank is chartered as an ILC in the handful of states that have the ability to charter ILCs. BPI urges Congress to act soon to ensure that the financial system and America's consumers are protected from heightened risks posed by the advance of large technology firms into the banking system while avoiding the framework established for the corporate owners of full-service insured banks. The time to close the ILC loophole is now, before it further undermines the principles that form the bedrock of banking supervision and regulation in the United States.