BANK POLICY INSTITUTE

Don’t Create a New Loophole When Closing the ILC Loophole

BPI Staff | April 27, 2022

As Congress and policymakers debate the appropriate regulatory framework for ensuring that digital assets and crypto-related activities are conducted in a safe and responsible manner, an existing statutory loophole could undermine those efforts if it is not closed: the Industrial Loan Company (ILC) loophole. It essentially allows Big Tech and other nonbank, commercial companies to own an FDIC-insured bank without adhering to the federal statutory, regulatory and examination regime that ordinarily applies to a company that controls a bank. In other words, an ILC parent company could engage in digital and crypto (and other commercial) activities, yet not be subject to the same comprehensive consolidated supervision as a bank holding company.

The loophole that exists today is not at all what Congress intended in 1987 when it passed the Competitive Equality Banking Act, which included a special provision sponsored by Utah Senator and then-Chairman of the Senate Banking Committee Jake Garn excluding ILCs from the definition of “bank” in the Bank Holding Company Act (BHCA).[1] At the time, nearly all 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. At 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.[2] But by 2020, there were 23 ILCs with combined assets of $164 billion, many of which are owned by commercial firms or belong to some of the largest nonbank financial services companies in the U.S.[3] Thus, the modern entities seeking to take advantage of this loophole today are very different from the ILCs that existed in the late ‘80s for whom this statutory exclusion was intended.

While Dodd-Frank imposed a temporary ILC moratorium, that moratorium was lifted by the FDIC a few years ago. Since that time, Square Financial Services (now Block) and Nelnet have acquired ILCs, and meanwhile, Japanese e-commerce giant Rakuten has submitted a third ILC application, having withdrawn two prior applications. Unlike Block and other applicants whose primary service offering is financial services, Rakuten conducts a vast commercial business. Of course, if a non-financial company like Rakuten were granted an ILC charter, the floodgates would open. There are doubtless many such commercial companies waiting for such a moment.

Granting Rakuten or another Big Tech company an ILC charter would upend the longstanding barrier that exists between banking and commerce that Congress established almost a century ago and allow that company to operate without robust consolidated supervision and regulation. Further, granting such a charter would provide that entity with access to consumer financial data that it could use in combination with the consumer data it collects through its tech business in a way that disadvantages consumers and other financial market participants.

[1] ILCs are a big industry in Utah, with 14 of 23 ILCs as of 2020 being chartered in the state.
[2] See Johnson and Kaufman (2007). Utah implemented a moratorium on new ILC charters after several ILCs in the state experienced significant financial difficulties, resulting in the need for $45 million of state assistance to meet depositor claims.
[3] Perkins, David. (2020). *Industrial Loan Companies (ILCs): Background and Policy Issues* (CRS Report No. R46489). Retrieved from Congressional Research Service website: https://sgp.fas.org/crs/misc/R46489.pdf

This is, of course, all reminiscent of the mid-2000s when Wal-Mart and Home Depot both applied for an ILC, which prompted intense public and bipartisan congressional opposition at the time.

Since the creation of the ILC loophole, policymakers have deliberated at various times about how to close the loophole fairly without disadvantaging those entities that currently have ILCs. Some have argued that subjecting such companies like Toyota or insurance companies — typically regulated at the state level — to a strict federal regulatory regime overseen by the Federal Reserve would be too onerous. As a result, Rep. Jesus "Chuy" Garcia (D-IL) has introduced bipartisan legislation to solve this problem by "grandfathering" existing ILCs to remain supervised by the FDIC while closing the loophole for the parent companies of any future ILC.

The key to striking this delicate balance between fairness for existing ILCs and preserving the fundamental separation of commerce and banking is a provision in the bill that stipulates the circumstances under which a parent company of a current ILC could sell its ILC to another company. In essence, this section generally would prohibit other commercial companies, as well as other companies not subject to a BHC-equivalent regulatory regime, from acquiring an existing ILC. Without this section, a current parent company of an ILC could sell its subsidiary ILC to the highest bidder, which could include a Big Tech company seeking access to the banking system. Such charters would be hot commodities indeed.

The current legislative draft from Rep. Garcia represents a balanced solution that would close the ILC loophole while providing generous concessions to and fair treatment of existing ILCs by allowing them to remain supervised by the FDIC. Unfortunately, this "change in control" section has become the latest point of contention with this legislation as some parent companies of ILCs have fought vigorously to retain the ability to sell their ILCs to *any* company. This would defeat the purpose of the legislation by creating a completely new loophole for a commercial company to obtain an ILC even after a congressional prohibition on new ILC applications would close the original loophole.

Two weeks ago, a large coalition of groups representing banks of all sizes, credit unions and consumer groups sent a letter of support for the latest version of the legislation, particularly noting that maintaining the change in control provision was critical. We encourage members of the House Financial Services Committee to swiftly take up this thoughtful and measured proposal without any changes that would potentially create an entirely new loophole after closing the ILC loophole.

Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute's member banks, the G30 or the G30 Working Group on Treasury Market Liquidity and are not intended to be, and should not be construed as, legal advice of any kind.