A bank by any other name …

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Introduction and summary

Banks come in a wide variety of forms. These include commercial banks, savings banks, savings and loans, and credit unions. But, all banks are not perceived as equally vital to the economy so as to require the same degree of government regulation to promote their safe and efficient operation. To regulate efficiently, it is necessary to carefully define the entity to be regulated. The issue of what constitutes a bank for regulatory purposes emerged in 2005 from being an arcane subject of interest primarily to a small number of regulatory attorneys to being of interest to a much larger and broader group. This interest was sparked when the large retailer Wal-Mart applied to the Federal Deposit Insurance Corporation (FDIC) to obtain federal deposit insurance for a newly chartered "bank" in Utah that was not subject to the ownership restrictions applicable to most other "banks." This article examines the definition of "bank" for financial regulatory purposes, traces and explains the evolution of the definition through time, and explores the controversy surrounding the recent attempt by Wal-Mart to establish its own bank. Wal-Mart has since withdrawn its application.

All depository institutions, including commercial and savings banks, need to obtain a special charter from either the federal government or their home state government rather than a general corporate charter. The charter identifies the activities in which the institutions are permitted to engage. Each chartering and regulatory agency specifies a definition of "bank" to which its authority applies. Restrictions on permissible activities may be imposed by the FDIC on insured banks and by the Board of Governors of the Federal Reserve System on holding companies that own bank subsidiaries.

The definition of bank need not be the same across agencies nor for any one agency through time. Differences and changes in definition may occur for a number of reasons, including differences in regulatory objectives among agencies, changes in legislation, changes in the demand for different types of financial services, changes in the supply of particular financial services, innovations in financial products and institutions, and changes in the operations of financial institutions.

In recent months, controversy about the definition of a bank has been ignited by an attempt, since abandoned, by Wal-Mart to obtain FDIC insurance for an industrial loan company (ILC) to be chartered in Utah.[1] An ILC is a "bank" chartered in a limited number of states that is granted the same or slightly fewer product powers than are commercial banks chartered in that state. Importantly, ILCs are currently explicitly exempted from the definition of "bank" in the Bank Holding Company Act (BHCA) if, among other characteristics, they do not accept demand deposits when their assets exceed $100 million. As long as the proposed ILC had satisfied these conditions, the parent holding company Wal-Mart would not have been legally classified as a bank holding company—a holding company that owns one or more institutions legally defined as a "bank"—and would have been subject neither to regulation by the Federal Reserve nor to the restrictions of the Bank Holding Company Act. If it had been, the nonfinancial activities of the parent company Wal-Mart would have prohibited its ownership of a bank subsidiary.

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To some, this "loophole" in the legal definition of a bank permits the piercing of the separation of banking (financial) and commerce (nonfinancial) that the BHCA was designed to maintain and is perceived as providing holding companies owning an ILC an unfair advantage over holding companies that own legally defined banks, such as commercial banks. This generated opposition to the Wal-Mart application for FDIC insurance, which was necessary for it to be an ILC that is exempt from the restrictions of the BHCA. In response to this opposition, the FDIC imposed a six-month moratorium in July 2006 on this and all other pending applications for federal insurance either for a new ILC or for an existing ILC undergoing a change in control through January 31, 2007. The FDIC then extended the moratorium in January 2007 for another year on new and pending applications from commercial (nonfinancial) firms for the operation of federally insured ILCs. This moratorium is due to expire on January 31, 2008.[2] In March 2007, Wal-Mart withdrew its application.

Evolution of the definition of "bank" and "bank holding company"

A bank is a type of financial institution. A financial institution is an entity that deals primarily in financial instruments and derives most of its revenues from interest and fees charged on its loans, investments, and deposits, or from trading in these securities. A popular dictionary of banking terms defines a bank as

> [an organization,] usually a corporation, that accepts deposits, makes loans, pays checks, and performs related services for the public.[3]

What differentiates a bank from most other financial institutions is that a bank can accept deposits of funds that the bank may re-lend but that need to be repaid to the depositor at full value at a future specified or unspecified date. As such, banks belong to the broader class of depository institutions, which includes other institutions that are chartered to accept deposits and make loans but traditionally have provided a narrower and more specialized range of services, such as savings and loan associations and credit unions.

As noted, unlike most other business corporations, banks require a special corporate bank charter from a government entity; in the United States this is either from the federal government (national bank) or the home state government (state bank).[4] Their powers are defined in the charter. For example, national banks chartered by the Comptroller of the Currency may:

> exercise … all such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security. …[5]

The National Bank Act, as currently amended, specifies individually the permissible powers in addition to deposit taking and loan making.

The charter imposes both advantages and disadvantages on a bank. The institution can offer various types of deposits, such as demand, time, and savings. These deposits are currently insured up to a maximum amount of $100,000 per eligible account by the Federal Deposit Insurance Corporation, which is an agency of the federal government. The bank is also provided direct access to the national payments system through the Federal Reserve's check and electronic clearing facilities. To the extent that bank charters are not granted freely, the chartering agencies may restrict entry and reduce competition.

In return for these advantages, the charter subjects the bank to a number of disadvantages in the form of costly regulation and supervision for reasons of safety, fairness, efficiency, and monetary policy. In the words of former Federal Reserve Chairman Paul Volcker:

> Handling other people's money, which is what banking is all about, connotes a fiduciary responsibility. …To that end, banking systems in virtually all countries are regulated.[6]

Types of regulation and supervision that have been frequently imposed on chartered banks include:

- Restrictions on types of products and services that may be offered;
- Restrictions on the number and location of offices;
- Minimum capital requirements;
- Restrictions on ownership by holding companies;
- Restrictions on mergers with other banks;
- Restrictions on interest paid on deposits and charged on loans;
- Examination by bank regulatory agencies for financial soundness and compliance with other regulations;
- Frequent reporting of financial condition to the regulatory agencies; and
- Special nondiscrimination lending and reporting requirements.

Until relatively recently, the term bank was often defined only loosely in federal legislation.[7] For example, the Federal Reserve Act of 1913 defines bank

TABLE 1

Changes in definition of bank in Bank Holding Company Act

Year	Definition
1956	Any national or state-chartered commercial, savings, or trust bank
1966	Any institution that accepts demand deposits
1970	Any institution that both accepts demand deposits and makes business loans
1987	All banks insured by the FDIC except thrifts, credit card banks, and industrial loan companies and banks

TABLE 2

Changes in the definition of bank (savings and loan) holding company for purposes of Holding Company Act

Year	Change
1956	Bank Holding Company Act (BHCA) applied to holding companies (HC) owning two or more chartered banks
1967	Saving and Loan Association Holding Company Act (SLHCA) applies provisions similar to BHCA to S&Ls owning two or more institutions
1970	BHCA expands definition of covered HC to owning only one bank or more
1987	BHCA expands covered HCs to any owning one or more FDIC insured banks but lists specific exemptions
1999	Gramm–Leach–Bliley Act expands definitions of SLHCA to an S&L owning one or more institutions

> to include state bank, banking association, and trust company, except where national banks or Federal Reserve banks are specifically referred to.[8]

The important Banking Act of 1933 (Glass–Steagall) refers to the definition used in the Federal Reserve Act. However, the term bank came to be more precisely defined with the Bank Holding Company Act of 1956. The definition of the term bank reflects the primary purpose of the act, which was to prevent both excessive economic concentration in banking and conflicts of interest that could arise if banks and nonbanks were under common ownership, enabling banks to provide preferential treatment to customers of their affiliates.[9] (The major changes in the legislated definitions of "bank" and "bank holding company" since 1956 are summarized in tables 1 and 2.)

Thus, the act restricted the nonfinancial activities of bank holding companies (BHC), prohibited bank holding companies from owning subsidiaries that engage in nonfinancial activities or in financial activities that were defined by the Federal Reserve as not being so closely related to banking as to be incidental to it, and restricted the ability of bank holding companies to acquire banks in other states.[10] The Fed developed a "laundry list" of financial activities that it considered sufficiently incidental to banking to be offered by nonbank subsidiaries of BHCs. Although commercial banks were generally prohibited from engaging in nonfinancial (commerce) activities by their charters, there were no previous restrictions on the activities of subsidiaries of holding companies that also owned one or more chartered banks or of the nonfinancial activities of such a holding company.

To achieve its objective, the BHCA needed to define "bank holding company." Because the major concern with both excessive economic concentration and conflicts of interest was with respect to banking firms, the act defined bank holding company with respect to the type of bank that it owned or controlled. The definition in the 1956 act defined "bank" to include:

> any national banking association or any State bank, savings bank, or trust company…[11]

and "bank holding company" as any corporate firm that owned two or more banks so defined.[12] In addition, bank holding companies had to register with the Federal Reserve and receive permission from the Fed for further acquisitions.

In time, the BHCA's definition of a bank was viewed as broader than necessary to achieve its objectives, as the definition included many types of financial institutions that were unlikely to produce excessive economic concentration or meaningful conflicts of interest if owned by a holding company that also owned nonbank subsidiaries. Thus, in 1966, the Bank Holding Company Act was amended to define a bank more narrowly as:

> Any institution that accepts deposits that the depositor has a legal right to withdraw on demand. ...[13]

This amendment changed the definition of bank from a chartering test to an activities test. Because deposits subject to withdrawal on demand (demand deposits) were at the time generally restricted to commercial banks, this definition effectively defined a bank holding company only as a company that owned two or more commercial banks.

The Senate report that accompanied this and other amendments at the time to the BHCA explained the reason for the change as follows:

> Section 2(c) of the [1956 BHCA] defines "bank" to include savings banks and trust companies, as well as commercial banks. The purpose of the [BHCA] was to restrain undue concentration of control of commercial bank credit, and to prevent abuse by a holding company of its control over this type of credit for the benefit of its nonbanking subsidiaries. This objective can be achieved without applying the [BHCA] to savings banks, and there are at least a few instances in which the reference to "savings bank" in the present definition may result in covering companies that control two or more industrial banks. To avoid this result, the bill redefines "bank" as an institution that accepts deposits payable on demand (checking accounts), the commonly accepted test of whether an institution is a commercial bank so as to exclude industrial banks and nondeposit trust companies.[14]

Note the express exclusion of industrial banks in the legislative history from the definition of "bank" for purposes of the act.

In 1970, the definition of "bank" for purposes of the act was narrowed further to:

> any institution organized under the laws of the United States, any State of the United States … which 1) accepts deposits that the depositor has a legal right to withdraw on demand, and 2) engages in the business of making commercial loans.[15]

This definition excluded a few institutions that accepted demand deposits but did not make business loans. Lending for noncommercial purposes was considered less likely to cause the problems that the act was designed to prevent. In addition, in response to a sharp increase in the number of holding companies owning only one bank and engaging in activities not permitted for holding companies owning two or more banks, the 1970 amendments also broadened the definition of a bank holding company to cover ownership of only one bank so defined.

In the early 1980s, however, an increasing number of bank holding companies organized or purchased banks that either accepted demand deposits but did not make commercial (business) loans or made commercial loans but did not accept demand deposits. Thus, they were not defined as "banks" for purposes of the act at that time. These institutions became known as "nonbank banks." Holding companies that owned such nonbank banks were not subject to the restrictions of the act that were imposed on holding companies that owned banks that met the definition of the act, particularly the prohibition against banks being owned by companies that were nonfinancial firms or owned them. Indeed, most but not all of the newly chartered nonbank banks were owned by holding companies that also owned nonfinancial firms.

To restrict this type of holding company going forward, the act was amended in 1987 by the Competitive Equality Banking Act (CEBA) to broaden the definition of bank from institutions that both accept demand deposits and make business loans to all banks insured by the FDIC.[16] (Existing nonbank banks were grandfathered, but subject to asset growth restrictions.) However, this definition captured some banks and other financial institutions that were generally considered unlikely to cause either excessive economic concentration or conflicts of interest if they were owned by a nonfinancial holding company or by a holding company that owned financial companies that were not on the Federal Reserve's permissible list.

To address this problem, the CEBA amendments for the first time specifically excluded from the definition of "bank" foreign banks, federally insured savings and loan associations, credit unions, credit card banks, and most federally insured industrial loan companies. However, as seen earlier, ILCs were already noted as not being a target of the BHCA in the Senate report accompanying the 1966 amendments. What most of these exempted institutions had in common is that, at the time, while they generally accepted deposits and made loans, they did not offer demand deposits and did little, if any, commercial lending. Companies that owned such excluded institutions were not subject to the act's restrictions. In explaining his support for the new definition, Paul Volcker, Chairman of the Board of Governors of the Federal Reserve System at the time, testified before the Senate Banking Committee:

> Essentially, the nonbank bank has become a device for tearing down the separation of commerce and banking by permitting a commercial firm to enter traditional banking business without abiding by the provisions of the Bank Holding Company Act. … Fundamentally at stake is not a few in-house consumer banking offices of some retail chains. … We want to protect against instability, excessive concentration of power, and undue conflicts of interest, while preserving the institutional framework for monetary policy. In seeking these goals, the separation of banking and commerce has been a basic part of the American tradition for what seems to me sound reasons.[17]

The specific exemption for industrial loan companies and industrial banks in CEBA was introduced in the final drafting of the act by then Senators Alan Cranston of California and Jake Garn of Utah, who served on the Senate Banking Committee and represented the two states with the largest number of such institutions.[18]

In 1999, Congress effectively reaffirmed the ILC exemption from the definition of "bank" and thereby also the restrictions of the BHCA, when it included a provision in the Gramm–Leach–Bliley Act (GLBA) that slightly expanded the permissible activities of eligible ILCs but did not otherwise change the exemption.

It is evident from this chronology of the evolution of the definition of both "bank" and "bank holding company" for regulatory purposes that the legal definition at any moment in time reflects the pressing public concerns of the time. As the concerns changed, so frequently did the definitions.

Industrial loan companies

Partially as a result of the broadening of the definition of bank in the BHCA through time, both nonfinancial (commercial) firms that wished to own a bank and were prohibited from doing so by the BHCA and nonbank financial companies that wished to own banks but did not wish to be legally classified as a bank holding company, and therefore be subject to Federal Reserve regulation, became more restricted in their options. ILCs were a remaining available option.[19] CEBA explicitly exempted ILCs from the definition of bank in the BHCA if:

1. In 1987, the state in which they were chartered required them to be insured by the FDIC, and either
2. They have less than $100 million in assets or, if greater, they do not offer demand deposits,[20] or
3. There has been no change in control since 1987.

In addition, in 1999, some firms that could have owned a single (unitary) thrift institution were brought under the restrictions of the Savings and Loan Holding Company Act (SLHCA) by the Gramm–Leach–Bliley Act. However, such firms may have preferred an ILC because, unlike a thrift institution, an ILC is not subject to the qualified lender provision, which effectively requires thrifts to hold a minimum percentage of mortgage loans in their portfolios.[21]

Seven states that charter ILCs satisfy the federal deposit insurance requirement of CEBA. They are California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah. A number of companies that wanted to escape the restrictions of the BHCA or SLHCA chose to purchase or organize ILCs in these states, primarily in Utah, California, and Nevada, or to grow existing ILCs faster than they would have otherwise.

ILCs originated in the early 1900s as small depository institutions, aimed primarily at the financial needs of low- and moderate-income households that were not being well served by existing larger financial institutions. They differed little either in mission or in operation from other consumer-oriented smaller financial institutions of the day, such as Morris Plan banks and credit unions.[22] They were chartered only at the state level, but could generally branch across state lines. ILCs remained relatively small until the end of the 1990s when their aggregate asset size jumped dramatically, even though they declined in number. Although the FDIC has insured Morris Plan banks since the FDIC's establishment in 1934, ILCs became eligible for FDIC insurance only in 1982, after the enactment of the Garn–St Germain Act.

Since the enactment of CEBA in 1987, when the ability of firms to avoid the BHCA restrictions by owning banks that either did not take demand deposits or did not make business loans was terminated, aggregate assets at federally insured ILCs increased from less than $5 billion to more than $150 billion by year-end 2006. All but $15 billion of this increase occurred since 1998, when the ability of additional firms to avoid the restrictions of the SLHCA by owning only one thrift institution (unitary thrift holding companies) was terminated by the Gramm–Leach–Bliley Act of 1999. Despite their rapid growth, ILCs account for less than 2 percent of total assets at FDIC insured institutions.[23]

At the same time, the number of federally insured ILCs declined sharply from 105 to 59.[24] Only three of the largest 15 ILCs in 1987 remained active in 2006. By far, the largest increase in ILC assets in this period occurred in Utah, which increased its market share of national ILC assets from 11 percent to 82 percent by 2004.[25] Both the rapid growth of ILCs in total and the particularly rapid growth in Utah can be explained in part by changes in Utah's legislation and the state's supportive regulatory environment for ILCs.[26] In 1986, Utah put a moratorium on new ILC charters after a number of ILCs had experienced significant financial difficulties that required some $45 million of state assistance to meet their depositor claims. The moratorium was lifted in 1997 after the industry regained its financial health, and the number of charters grew from 18 to 33 by June 30, 2006. Total assets also grew from $18 billion in 1997 to $133.8 billion in 2006.[27] Over the same period, the size of the individual institutions has also changed greatly. In 1987, the largest Utah chartered ILC had $290 million in assets.[28] At year-end 2006, the largest ILC in Utah reported assets of $67 billion.[29]

owned by GM, which was undergoing major restructuring, to a consortium of four financial institutions. BMW uses its Utah ILC to finance sales of BMW automobiles and motorcycles, and the retailer Target uses its Utah ILC to finance its in-house credit card sales for small business customers.

The wide variety of both ownership and business lines of ILCs is reflected in the eight types of business models into which the two principal ILC trade groups divide the industry: 1) ILCs owned by securities companies, 2) ILCs owned by commercial finance companies, 3) ILCs owned by consumer finance companies, 4) ILCs owned by a commercial company conducting an independent core financial services business, 5) commercially owned ILCs offering financial services to customers of the corporate group that are not affiliate transactions, 6) ILCs owned by a commercial company that finance transactions with affiliates subject to the restrictions in Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act, 7) ILCs owned by title insurance holding companies, and 8) independently owned ILCs.[32] A brief description of each business model and an ILC example are shown in table 4.

Primarily because of the rapid growth of ILCs in recent years and the ongoing controversy surrounding Wal-Mart itself, its application for required FDIC insurance for its proposed ILC in Utah attracted immediate attention and widespread opposition from many bankers, retailers, and policymakers, including members of Congress. The opposition arose despite Wal-Mart's stated intentions in the application of not engaging in full-service banking, but only in credit and debit card and fund transfer (payments system) operations. At its filing, the application raised at least two important public policy issues:

1. Should a decision to increase the mix between banking and commerce be made administratively

TABLE 4

ILC business models

Business model	Description	ILC example
Banks owned by securities companies	Provide commercial and consumer credit to customers of securities companies	Merrill Lynch Bank USA
Banks owned by commercial finance companies	Provide commercial loans to customers that are not customers of an affiliate	Advanta Bank
Banks owned by consumer finance companies	Provide credit cards and other forms of consumer credit and services to customers that are not customers of affiliates	American Express Centurion Bank
Banks owned by a commercial company conducting an independent core financial services business	Provide traditional banking services to customers that are not customers of affiliates	GE Capital Financial
Commercially owned banks offering financial services to customers of the corporate group that are not affiliate transactions	Provide credit and financial services to customers of owner	BMW Bank of North America
Banks owned by a commercial company that finances transactions with affiliates subject to the restrictions in Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act	Provide credit to customers of affiliates (credit and services are subject to the covered transaction rules)	Target Bank
Banks owned by title insurance holding companies	Provide financial services	First Security Thrift
Independently owned banks	Provide financial services (owners not engaging in commercial activities prohibited by bank holding company rules)	Celtic Bank

Source: Utah Association of Financial Services and California Association of Industrial Banks (2006).

by a regulatory agency within the authority Congress granted it, or should it be made legislatively by Congress in the light of the changed circumstances described earlier?, and

2. Are the current regulatory prudential powers of the FDIC sufficient for consolidated supervision of ILC holding companies relative to the prudential powers of the Federal Reserve for bank (financial) holding companies under the BHCA?

Because Wal-Mart was not the first large nonbank firm to have received or applied for FDIC insurance for an ILC or even the first large commercial firm—only the most controversial—these two issues were not necessarily muted by the withdrawal of the application. As discussed earlier, large firms, such as Merrill Lynch, General Motors (until recently), BMW, and Target all own ILCs. Home Depot has an insurance application pending, but action on it has been delayed by the moratorium.

Public policy issues

The mixing of banking and commerce

The mixing of banking and commerce in "universal" banks, as exists in many countries, has long been controversial in U.S. banking history. Most state charters for banks and the federal charter for national banks limit the activities of banks to accepting deposits and making loans, but permit other services viewed as incidental to banking. This was generally interpreted by regulators as prohibiting the banks from engaging in some financial activities, such as insurance underwriting and real estate brokerage, and all nonfinancial activities. Until the enactment of the BHCA in 1956, these limitations were not generally applied to bank holding companies, so that commercial firms could own banks. Thus, Ford Motors and Sears, among other large nonfinancial firms, operated banks. But, as discussed earlier, growing fears in the 1950s that such combinations could lead both to excessive economic and social power and to potential conflicts of interest favoring sellers resulted in the enactment of the BHCA in 1956 and its expansion in 1970. Since then, the thrust of legislation, which often is preceded by changes in the marketplace, has reversed. The financial powers of BHCs have been expanded significantly, most recently in the Gramm–Leach–Bliley (Bank Modernization) Act of 1999, and the nonfinancial powers have been expanded moderately. However, unlike ILCs, commercial banks may still not be owned by commercial firms.

Two questions appear to arise going forward. First, the ILC industry has changed dramatically since 1987, when ILCs were first specifically exempted from the restrictions of the BHCA primarily because they were small and insignificant on a national scale. Thus, it may reasonably be asked whether this issue has now become sufficiently important that further piercing of the separation of banking and commerce is too important to leave to the regulatory agencies by default.[33] Rather, does it now deserve a review by Congress?[34] Indeed, in her explanation for the one-year extension of the moratorium on granting insurance to additional ILCs owned by commercial firms in January 2007, the FDIC Chairman, Sheila Bair, noted that "The moratorium will provide Congress with an opportunity to address the issue legislatively."[35,36]

In particular, it may be asked if Congress would have specifically exempted ILCs from the BHCA in earlier years had some of the institutions been as large then as they are today? For example, the largest ILC in 1987 had total assets of only some $400 million. Indeed, only one of the current largest 15 ILCs was chartered and federally insured before 1987. It is effectively a new industry. In testimony at the FDIC's open hearing on the Wal-Mart application, former Senator Garn, who sponsored the exemption in 1987, stated that he had not intended for ILCs to move into the retail banking business and now opposes such expansion.[37] Moreover, if after review, Congress determined that increased mixing of banking and commerce is desirable, should this be limited to ILCs, or should it be extended to all bank and financial holding companies to level the playing field?[38]

Second, by 1999, when Congress last retained the ILC exemption by broadening it slightly, the ILC industry had already begun a rapid expansion. The largest ILC, owned by American Express, had assets in excess of $15 billion, and four other ILCs had assets in excess of $2 billion each; one of these was owned by a commercial firm. Thus, if Congress was not sufficiently concerned at the time, and has taken no action since, some may question whether it is appropriate for a regulatory agency to delay approval of applications that are not in conflict with existing law until Congress acts. Indeed, some have suggested that, in this instance, the issue goes beyond whether the mixing of banking and commerce is appropriate and may be an issue with Wal-Mart per se.[39] Wal-Mart is the world's largest retailer with an extensive distribution network and a perception as utilizing aggressive marketing and labor practices.[40]

Indeed, an application for a Utah chartered ILC by large retailer Target in 2004 was viewed as sufficiently routine by the FDIC to be approved at the staff level rather than by the FDIC's board of directors.[41] Nor did the approval of the application ignite much public opposition. In contrast, Wal-Mart's application

to the FDIC attracted nearly 14,000 written letters, including 150 from members of Congress, almost all opposed to the application, and caused the FDIC to schedule three days of open hearings that attracted some 70 witnesses, again almost all opposed.[42]

Although Wal-Mart has withdrawn its application, there is some concern that, in the absence of congressional action, it may reapply in the future, after the expiration of the moratorium. Wal-Mart has recently established a full-service bank in Mexico and has announced its intentions to offer a wide range of nonbank financial services at its U.S. stores.

The FDIC's prudential authority over ILCs

Because ILCs are state-chartered FDIC insured institutions and none have chosen to be members of the Federal Reserve System, their primary federal regulator is the FDIC. In addition, they are regulated by the banking agency in the state in which they are chartered. All three federal regulators of commercial banks—the Comptroller of the Currency, the Federal Reserve, and the FDIC—have effectively the same statutory prudential authority for the banks they supervise. But this is not necessarily true for their authority over parent holding companies of these banks. The Federal Reserve has clear authority under the BHCA to supervise and examine bank holding companies, as defined in the act, on a consolidated basis.[43] This would include the operation of the parent holding company, subsidiary banks, and any subsidiary nonbank firms. The underlying justification for such consolidated supervision is that these entities are usually managed in terms of risk exposures on a centralized or consolidated basis, so that full understanding of the risk exposure of any one component of the entity requires knowledge of all components combined.

Consolidated top-down supervision is widely viewed as necessary despite the fact that Federal Reserve regulations 23 A and B limit the amount of transactions between the bank and the other affiliates of the holding company and require that permissible transactions be priced on an "arm's length" basis. These regulations attempt to isolate the bank subsidiary from the other components of the holding company, so that the bank more closely resembles an independent, freestanding institution. A recent study (table 5) by the federal government's Government Accountability Office (GAO) compared the current statutory consolidated supervision powers of the FDIC and Federal Reserve (as well as the Office of Thrift Supervision for parent holding companies of savings and loan associations) and found the FDIC's weaker.[44]

For example, with limited exceptions, the FDIC focuses on the ILC itself rather than the parent on a consolidated basis—a bottom-up approach. The FDIC generally examines or imposes sanctions and enforcement actions on the parent company or its non-ILC affiliates only if it is concerned about the financial condition of the insured ILC. Thus, for example, the FDIC recently issued a cease and desist order against the Fremont Investment and Loan (an ILC) in California and its parent holding companies for problems at the ILC related to its underwriting of subprime mortgage loans without noting either the large losses simultaneously experienced for the same reason by the parents or requiring similar changes to be made by them as at the subsidiary ILC.[45] Major differences in the explicit supervisory powers of the federal agencies over parent holding companies of insured depository institutions according to the GAO are shown in table 5.

To some, the more limiting powers over parent holding companies may hamper the FDIC's ability to evaluate and protect the safety and soundness of ILCs. Partially in recognition of this concern, the FDIC announced in its extension of the moratorium that it had proposed a regulation that would provide for enhanced supervision of ILC parent holding companies that engage only in financial activities to ensure their ability to provide financial support to their institutions and require them to maintain the capital of the ILC at a specified minimum level.[46] This proposal is still pending. The proposal did not include parent holding companies that engage in nonfinancial activities, pending additional study by both the FDIC and Congress.

Recent developments

In May 2007, the House of Representatives passed the Industrial Bank Holding Company Act of 2007 that would prohibit any firm that receives more than 15 percent of its annual gross revenues on a consolidated basis from nonfinancial activities from owning or controlling an ILC. On October 4, 2007, the Senate Banking Committee held hearings on Senate Bill 1356, which is identical to the House bill. Firms that owned an ILC before January 28, 2007, were generally grandfathered. But, an ILC subsidiary of a commercial firm that did not own the subsidiary before 2003 cannot engage in activities in which it did not engage in on January 28, 2007, or operate branches in states in which it did not operate branches on that date. The act would also broaden the FDIC's authority to examine and require reports from the ILC parent holding company and affiliates and to enforce sanctions and capital standards on the ILC parent holding company and affiliates. This change would bring the regulatory environment for ILC holding companies into greater conformity with that for

TABLE 5

Comparison of explicit supervisory powers of the FDIC, Federal Reserve Board, and OTS

Description of explicit supervisory authority	FDIC[a]	Board	OTS
Examine the relationships, including specific transactions, if any, between the insured institution and its parent or affiliates.	●[b]	●[b]	●[b]
Examine beyond specific transactions when necessary to disclose the nature and effect of relationship between the insured institution and the parent or affiliate.	●[b]	●[b]	●[b]
Examine the parent or any affiliate of an insured institution, including a parent or affiliate that does not have any relationships with the insured institution or concerning matters that go beyond the scope of any such relationships and their effect on depository institution.	○	●[b]	●[b]
Take enforcement actions against the parent of an insured institution.	⦿[b,c]	●[b]	●[b]
Take enforcement actions against affiliates of the insured institution that participate in the conduct of affairs of, or act as agents for, the insured institution.	⦿[b]	●[b]	●[b]
Take enforcement actions against any affiliate of the insured institution, even if the affiliate does not act as agent for, or participate in the conduct of, the affairs of the insured institution.	○	●[b]	●[b]
Compel the parent and affiliates to provide various reports such as reports of operations, financial condition, and systems for monitoring risk.	⦿[b,d]	●[b]	●[b]
Impose consolidated or parent-only capital requirements on the parent and require that it serve as source of strength to the insured depository institution.	⦿[d]	●[b]	●[b]
Compel the parent to divest of an affiliate posing a serious risk to the safety and soundness of the insured institution.	⦿[e]	●[b]	●[b]

●Explicit authority.
⦿Less extensive authority.
○No authority.
[a]FDIC may examine an insured institution for interaffiliate transactions at any time and can examine the affiliate when necessary to disclose the transaction and its effect on the insured institution.
[b]The authority that each agency may have regarding functionally regulated affiliates of an insured depository institution is limited in some respects. For example, each agency, to the extent it has the authority to examine or obtain from a functionally regulated affiliate, is generally required to accept examinations and reports by the affiliates' primary supervisors unless the affiliate poses a material risk to the depository institution or the examination or report is necessary to assess the affiliate's compliance with a law the agency has specific jurisdiction for enforcing with respect to the affiliate (for example, the Bank Holding Company Act in the case of the Board). These limits do not apply to the Board with respect to a company that is itself a bank holding company. These restrictions also do not limit the FDIC's authority to examine the relationships between an institution and an affiliate if the FDIC determines that the examination is necessary to determine the condition of the insured institution for insurance purposes.
[c]FDIC may take enforcement actions against institution-affiliated parties of an ILC. A typical ILC holding company qualifies as an institution-affiliated party. FDIC's ability to require an ILC holding company to provide a capital infusion to the ILC is limited. In addition FDIC may take enforcement action against the holding company of an ILC to address unsafe or unsound practices only if the holding company engages in an unsafe and unsound practice in conducting the affairs of the depository institution.
[d]FDIC maintains that it can achieve this result by imposing an obligation on an ILC holding company as a condition of insuring the ILC. FDIC also maintains it can achieve this result as an alternative to terminating insurance. FDIC officials also stated that the prospect of terminating insurance may compel the holding company to take affirmative action to correct violations in order to protect the insured institution. According to FDIC officials, there are no examples where FDIC has imposed this condition on a holding company as a condition of insurance.
[e]In addition to an enforcement action against the holding company of an ILC in certain circumstances (see note b), as part of prompt corrective action the FDIC may require any company having control over the ILC to 1) divest itself of the ILC if divestiture would improve the institution's financial condition and future prospects, or 2) divest a nonbank affiliate if the affiliate is in danger of becoming insolvent and poses a significant risk to the institution or is likely to cause a significant dissipation of the institution's assets or earnings. However, the FDIC generally may take such actions only if the ILC is already significantly undercapitalized.
Notes: FDIC is the Federal Deposit Insurance Corporation. OTS is the Office of Thrift Supervision.
Source: Hillman (2006), pp. 15–16.

BHCs and give the FDIC powers over ILC holding companies more similar to those the Federal Reserve has over BHCs.

Wal-Mart withdrew its application to operate an ILC, but not its intention to engage in a wide range of bank-like activities for which a bank charter is not required. It has announced its intention to open "money centers" in its stores that will offer, among other financial products, low-cost prepaid stored-value cards as well as check cashing and money transfer (remittance) services. In addition, it will offer a Wal-Mart branded Visa debit card through a third party bank vendor.

Payroll and social security checks could be directly transmitted by customers to Wal-Mart to be added to the stored-value card or to support the debit card. This is intended to increase both safety and convenience over currency transfers. Through time, Wal-Mart has expressed intentions to add additional financial services directed largely at low-income "unbanked" customers.[47]

NOTES

[1]In some states, Utah, for example, industrial loan companies are referred to as industrial banks. The Wal-Mart application was initially filed in Utah for a charter in July 2005 and simultaneously with the FDIC for insurance. The FDIC application was withdrawn in March 2007. See Wal-Mart Stores, Inc. (2005).

[2]FDIC (2007b).

[3]Fitch (2000), p. 40.

[4]Depository institutions are one of the few types of corporations that may be chartered by either the federal government or the home state.

[5]National Bank Act, Chapter 106, Section 8, June 3, 1864, 13 Stat. 99, codified at 12 USC §24.

[6]Volcker (1987), p. 200.

[7]This section draws on Di Clemente (1983).

[8]Federal Reserve Act, 63rd Cong. Chapter 6, Section 1, December 23, 1913, 38 Stat. 251.

[9]Bank Holding Company Act of 1956, Senate report, No. 84-1095, July 25, 1955, pp. 1–4.

[10]The separation of banking and commerce was not complete. BHCs were permitted limited investment in nonfinancial firms. A review of the permissible nonfinancial activities of banks appears in Haubrich and Santos (2003).

[11]Bank Holding Company Act of 1956, Ch. 240, 70 Stat 133, Section 2(c). May 9, 1956.

[12]Ibid. Companies that owned or controlled savings and loan associations and other thrift institutions insured first by the Federal Savings and Loan Insurance Corporation (FSLIC) (and then the FDIC) were not defined as bank holding companies and were initially not subject to any restrictions. After the enactment of the Savings and Loan Holding Company Act (SLHCA) in 1967, those companies, for a time, were subject to lesser restrictions until 1999, when the BHCA and SLHCA became more comparable.

[13]Public Law 89-485, Section 3(c), July 1, 1966, 80 Stat. 236.

[14]S. Rep. No. 1179, 89th Cong., 2d Sess. 2391 (1966).

[15]Bank Holding Company Act of 1970 (Public Law 91-607), Sect. 2(c), December 31, 1970, 84 Stat. 1760.

[16]Competitive Equality Banking Act of 1987, PL100-86, Sect. 101, August 10, 1987, 101 Stat 552.

[17]Volcker (1987), p. 200.

[18]Comment submitted by Wal-Mart to the FDIC, October 10, 2006, Appendix 1, p. 40, available at www.fdic.gov. Wilmarth (2007, p. 1572), however, argues that Senator Garn's cosponsor was Senator William Proxmire of Wisconsin rather than Senator Cranston.

[19]If the parent holding company also owns a thrift institution, the company is subject to regulation by the Office of Thrift Supervision as a savings and loan holding company.

[20]This may not be overly restrictive since large ILCs may offer consumer NOW accounts, which resemble demand deposits.

[21]12 USC § 1467(a)(m)(1).

[22]For additional information about and the history of Morris Plan banks, see http://eh.net/encyclopedia/article/philips.banking.morris_plan.

[23]Hillman (2006), pp. 5–7. Jones (2006).

[24]There are apparently many more small ILCs that are not federally insured, not included in the federal statistics, and not exempt from the restrictions of the BHCA. Weiss (2007).

[25]Government Accountability Office (2005), p. 20.

[26]Sutton (2002).

[27]State of Utah, Commissioner of Financial Institutions (2006).

[28]State of Utah, Commissioner of Financial Institutions (2006). State of Utah, Commissioner of Financial Institutions (1987).

[29]See www.ibanknet.com (financial reports of industrial loan companies).

[30]Hillman (2006).

[31]Public Disclosure, January 10, 2006, Community Reinvestment Act Performance Evaluation, Merrill Lynch Bank USA, available at www.FDIC2.gov/crapes.

[32]Utah Association of Financial Services and the California Association of Industrial Banks (2006), pp. 11–13. See also Weiss (2007).

[33]For a summary of the public policy issues in mixing banking and commerce see Haubrich and Santos (2003), Blair (2004, 2007), and Ergungor and Thomson (2006).

[34]An analogous situation may be the demise of the controversial restrictions on underwriting and trading in private securities by banks and bank holding companies introduced in the Banking (Glass–Steagall) Act of 1933. In response to changing economic conditions and in the absence of congressional action, the Board of Governors and the other bank regulatory agencies slowly started to permit bank holding companies into these activities in 1982 through administratively liberalizing the interpretation of the restrictive language in the act for subsidiaries authorized in Section 20 of the Federal Reserve Act. Congress ultimately enacted liberalizing legislation in the Gramm–Leach–Bliley Act of 1999. For a history of these issues see Kaufman and Mote (1989, 1990).

[35]FDIC (2007c).

[36]The FDIC has approved a number of applications for insurance since the adoption of the moratorium from firms that it considers as financial or that propose activities by ILCs that are complementary to financial activities and thus are not covered by the moratorium. The extension of the moratorium applies only to ILCs to be owned by commercial firms and not by nonbank financial firms, which do not involve a mixing of banking and commerce.

[37]Wilmarth (2007), p. 1572

[38]Since the initial adoption by the FDIC in July 2006 of the moratorium on new and pending applications for federal deposit insurance for both new and existing ILCs undergoing a proposed change in control, assets at ILCs as a whole have increased sharply. In the six months before the moratorium, assets at the 25 largest ILCs at year-end 2006 increased by some $12 billion from $145 billion at year-end 2005 to $157 billion at midyear 2006, or 8 percent. In the six months following the moratorium, assets at these ILCs jumped by $51 billion, or fully 32 percent.

Most of this unusual spurt in asset size can be attributed to three ILCs—two are owned by nonbank financial firms and the third received special permission from the FDIC for a change in control from GMAC to a consortium of four financial firms in anticipation of a major restructuring of General Motors. The asset jump at these ILCs may have been precautionary, in case Congress limited the ILC exemption to the ownership restrictions of the BHCA. If so, these ILCs may have anticipated that, as frequently is the case, existing ILCs would be grandfathered but their future growth would be restricted.

[39]Featherstone (2005).

[40]Jorde (2003, 2006). This was not Wal-Mart's first attempt to establish and operate a bank or thrift institution. It had previously attempted to obtain a thrift institution in Oklahoma in 1998 and an ILC charter in California in 2002, but was denied first by the enactment of the Gramm–Leach–Bliley Act in 1999, which ended the unitary thrift exemption, and then by enactment of restrictions on commercial firm ownership of California chartered ILCs by the California state legislature. It currently leases space to branch offices of some 300 independent banks in more than 1,000 of its stores. But an earlier attempt in 2001 to have its own employees man such branch offices and share in the proceeds with a chartered thrift institution was denied by the Office of Thrift Supervision (Nolan, 2006).

[41]Adler (2007a).

[42]Wilmarth (2007), pp. 1545–1546. In addition, as of January 2007, five states had enacted legislation since the Wal-Mart application in Utah to prevent Utah chartered ILCs from branching further into their states, and another five were considering such legislation. (Adler, 2007b).

[43]The Office of Thrift Supervision (OTS) has similar consolidated supervisory authority for savings and loan holding companies. As of year-end 2006, eight of the 15 largest ILCs holding 71 percent of the assets of these ILCs were owned by parent companies that also owned a thrift institution and thus were classified as savings and loan holding companies and subject to OTS consolidated supervision (Reich, 2007).

[44]Hillman (2006). This has also been argued by Federal Reserve officials (Kohn, 2007).

[45]FDIC (2007a).

[46]FDIC (2007c). However, this still leaves them with weaker consolidated supervisory powers relative to the Federal Reserve. Equating the two would require congressional action.

[47]McWilliams (2007) and Barbaro and Dash (2007).

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