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IN FOCUS

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Industrial Loan Companies and Fintech in Banking

Several states offer a type of bank charter for *industrial loan companies* (ILCs). Certain features of ILCs and their regulation—particularly that their parent holding companies can be nonfinancial, commercial firms not supervised by the Federal Reserve—have made ILCs the subject of perennial policy debate. Recently, several technology companies have applied to establish new ILCs, refocusing interest on the issue.

Industrial Loan Companies

In the United States, depository institutions operate under a number of charter types offered at either the state or federal level. Each type determines which activities are permissible for the institution, which are restricted, and which federal bank agency or agencies will regulate the institution. In addition, a depository may be owned by a parent company, which in the vast majority of cases (ILCs excepted, as discussed below) is a *bank-holding company* or *thrift-holding company* (hereinafter collectively referred to as BHCs) regulated by the Federal Reserve.

Originally, ILCs formed to serve niche lending markets (the name comes from their initial business of making loans to industrial workers), were not allowed to accept deposits, and were restricted in the types of loans they could make. Over time, market changes and changes to state and federal law and regulation have narrowed the differences between the products and services provided by ILCs and by commercial banks and savings associations.

Table 1. ILC Statistics, Third Quarter 2019

Number	24
Total Assets	$141.4 billion
Total Deposits	$109.4 billion
Chartering States	UT (14); NV (4); CA (3); HI, IN, MN (1)

Source: iBanknet, accessed on November 21, 2019, at http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=ilc.

Currently, ILCs chartered in some states are allowed to accept certain types of deposits if the ILC is approved for deposit insurance by the Federal Deposit Insurance Corporation (FDIC). As a result, certain state charters allow ILCs to operate nationwide as full-service, FDIC-insured banks. Similar to state banks, the FDIC and a state agency regulate ILCs, and those agencies have the authority to prohibit or restrict certain transactions between the ILC and the parent holding company. Though the differences between banks and ILCs have narrowed, important legal and regulatory differences remain, two of which are the source of contentious debate.

ILCs can be owned by a nonfinancial parent company, creating an avenue for commercial firms (e.g., retailers, manufacturers, or possibly technology companies) to own a bank. This raises questions over whether ILCs create an unacceptable mixing of banking and commerce.

In addition, under federal law, an ILC parent company that meets certain criteria is not necessarily considered a BHC pursuant to the Bank Holding Company Act of 1956 (P.L. 84-511), and thus generally is not subject to regulatory supervision by the Federal Reserve. (An exception would occur in cases where an ILC or its parent is designated a *systemically important financial institution*, over which the Federal Reserve does have supervisory authority. See CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.) This may raise questions over whether appropriate regulatory supervision of ILCs is in place, and whether their regulatory treatment puts BHCs and their banks at an unfair competitive disadvantage.

Debated Issues

Separation of Banking and Finance. In general, the United States has historically adopted policies to separate banking (for the purposes of this In Focus, meaning deposit-taking) and commerce (i.e., buying and selling goods and services).

Rationales for such policies involve preventing a number of interrelated problems. One is that a mixed organization's banking subsidiary could have incentives to make decisions based on the larger organization's interests, rather than on safe and sound banking principles. For example, it may choose to make overly risky loans to customers of its commercial parent. While the bank subsidiary may suffer losses on such overly risky loans, the organization on the whole may not, since the loan proceeds were paid to the commercial parent to make a purchase. Meanwhile, the funding to undertake this imprudent lending would be backed by federal deposit insurance, which is ultimately backed by the taxpayers. For this reason, proponents of separating banking and commerce argue it prevents an inappropriate extension of bank safety nets to commercial enterprises. In addition, they argue that a combined enterprise, with financing operations in-house and in part funded through taxpayer-backed deposits, could more easily achieve the size and financial resources necessary to exercise anticompetitive market power. ILC opponents assert that commercial firms' ownership of ILCs exposes the U.S. banking system and economy to these risks.

In contrast, ILC proponents assert these concerns are overstated and do not justify preventing the potential realization of certain benefits. Potential benefits of mixed organizations include economies of scale (organizations can reduce costs with an in-house bank); risk diversification (mixed organizations are not entirely exposed to bank or commercial risks); information efficiencies (commercial companies may have knowledge about customers' creditworthiness or needs that a bank would not); and costumer convenience (financing and purchasing becomes "one-stop shopping"). Furthermore, they argue that current ILCs continue to fulfill their original role as important financial service providers to niche markets.

Different Treatment Between Charters. U.S. depository institutions operate under a number of charter types, and each is regulated differently. One of the rationales for this system is that it allows institutions with different business models and ownership arrangements to choose a regulatory regime appropriately suited to their business needs and risks. Under this system, a variety of institution types can be deployed to meet market needs. However, the fragmented regulatory framework can potentially create certain challenges. One is that, in some circumstances, institutions engaged in very similar businesses may nevertheless be subject to different regulations in such a way that one group is at a competitive disadvantage to another. Further, this system may create avenues for institutions to actively seek out charters and ways to structure themselves largely to side-step certain regulations, often characterized as finding loopholes.

The balance policymakers aim to strike is to have enough differentiation between charters and regulatory regimes to provide for appropriate tailoring, while not inadvertently creating regulatory gaps that could allow excessive risk to enter the banking system and economy. ILC opponents argue their parent company exemption from Federal Reserve supervision is an example of a problematic loophole. Proponents argue current FDIC and state ILC supervision is sufficient, and the charter allows companies to serve markets that would not be otherwise.

Controversies and Moratoriums

These issues played a prominent role in the public controversy sparked during Walmart's and Home Depot's ultimately unsuccessful efforts to secure ILC charters between 2002 and 2008. Public opposition to allowing the companies to acquire the charters generally focused on the market power and fairness aspects of allowing such large retailers with numerous locations nationwide to provide bank services. Many observers predicted the retailers would be able to use market power to run small banks out of business. In contrast, the efforts' proponents argued there could be cost savings in payment processing and that certain customers would be better able to access financial products at retail locations.

Amid that debate, the FDIC imposed an official moratorium in 2006 on the acceptance, approval, or denial of ILC applications for deposit insurance while the agency reexamined its policies related to these companies. That moratorium ended in January 2008. By that time, perhaps due in part to the public controversy or the then-unfolding financial crisis, Walmart and Home Depot had withdrawn from their attempts to secure a charter.

Continuing concerns over ILCs led Congress to mandate another moratorium (this one lasting three years, ending in July 2013) on granting new ILCs deposit insurance in the Dodd-Frank Act (P.L. 111-203). Even though this mandatory moratorium ended, as of today the FDIC has not approved any new ILC applications. Some ILC proponents have suggested that the FDIC has unilaterally placed a moratorium on approving ILCs, despite the fact that ILCs are permitted under current law.

Fintech Firms and Renewed Debate

Recently, four firms intending to start an ILC applied for FDIC insurance, although two of those have since withdrawn their applications. The remaining applicants are companies called Square and Rakuten. Square sells computer hardware and software that enable electronic payments to businesses. Rakuten is a Japanese online retailer that owns a shopper rewards company in the United States. Both are arguably financial technology (or *fintech*) companies that are primarily commercial in nature. In addition, observers have speculated that technology giants such as Google, Amazon, and Apple might have reason to want a bank charter, possibly including an ILC, in the near future.

ILC opponents argue new fintech firms can (particularly using the internet) very quickly become a large national presence, raising concerns over market power and the extension of government safety nets. The potential that one or more of the big tech companies conceivably would want a charter has heightened these concerns.

ILC and fintech proponents assert fintech firms can safely bring innovative and beneficial technologies into banking and potentially increase the availability of financial services, and the FDIC's apparent unwillingness to grant insurance is unjustified.

Selected Legislative Alternatives

Given recent developments, Congress may seek to address ILC policy issues. If Congress determines ILCs allow too much integration between commerce and banking, it could limit or prohibit commercial activity at parent companies that own ILC subsidiaries or revoke the FDIC's authority to grant ILCs deposit insurance. Conversely, if Congress determines ILCs are beneficial and well regulated, and that the FDIC is inappropriately holding up their applications, it could direct the FDIC to decide on applications without regard to whether the applicant is an ILC.

If Congress determines that the lack of Fed supervision of ILCs' parent holding companies is problematic, it could extend the Fed's regulatory authorities to include ILC holding companies. In the 116th Congress, S. 2839 would pursue this approach.

Finally, to consider the issues further, Congress could reinstate a moratorium on FDIC insurance approvals for ILCs.

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