GAO REPORT CONTRIBUTES TO THE INDUSTRIAL LOAN COMPANY DEBATE

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Government Accountability Office report GAO-05-621, entitled "Industrial Loan Corporations – Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," makes an interesting contribution to the debate surrounding industrial loan companies ("ILCs"). Dated September 15, 2005, the Report responds to a request by Congressman Jim Leach, dated March 4, 2004, seeking information on the following six issues:

1. the history and growth of the ILC industry; [2]

2. the permissible activities and regulatory safeguards for ILCs as compared with other insured financial institutions;

3. a comparison of the FDIC's supervisory authority over ILC holding companies and affiliates with the consolidated supervisors' authority over holding companies and affiliates;

4. recent changes the FDIC has made to its supervisory approach to the risks that holding companies and affiliates could pose to ILCs and determine whether the FDIC's bank-centric supervisory approach protects the ILC from all the risks that holding companies and nonbank affiliates may pose to the ILC;

5. whether the ILC charter allows for greater mixing of banking and commerce than other types of insured depository institutions, and whether this possibility has any competitive implications for the banking industry; and

6. the potential implications of granting ILCs the ability to pay interest on business checking accounts and to operate de novo branches nationwide.

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[1] The opinions expressed herein are those of the author alone. They do not necessarily reflect the views of other partners or employees of Venable LLP, or of any of its clients.
[2] For an excellent summary of the history of ILCs and their current legal status under federal banking law, see Ray Natter's article, *The Industrial Loan Company Controversy*, in the July 2005 issue of this newsletter.

It is not clear why the GAO took more than 18 months to respond to Congressman Leach's request, but the timing of its Report is nevertheless apt: Wal-Mart's pending application to charter a Utah ILC, despite the retailer's repeated assurances that it wishes to use the bank-like entity only to process credit and debit card charges, has given the ILC issue new prominence. It is also indisputable that ILCs have grown significantly in size in recent years, even as the absolute number of ILC charters has declined. As the Report notes, ILC assets grew from $3.8 billion to $140 billion between 1987 and 2004, and six ILCs had more than $3 billion in assets, with one holding more than $66 billion in assets. The owners of many ILCs are not obscure companies: they include nationally prominent industrial and financial concerns such as GE, General Motors, BMW, Volkswagen, Morgan Stanley, Goldman Sachs, Merrill Lynch, Citigroup, UBS and American Express. It is no longer possible to dismiss ILCs as niche players with little significance in the financial services marketplace.

Given that ILCs have most of the powers of commercial banks (with the notable exception of providing checking accounts, if the ILC has more than $100 million in assets),[3] and that other depository institution holding companies are both generally restricted to financial activities and subject, in varying degrees, to consolidated supervision, it seems reasonable to ask why the rules should be different for ILC holding companies. To put it another way, should ILC holding companies continue to be permitted to mix banking and commerce and, whatever the answer to that question, do they need to have a consolidated, umbrella supervisor like other depository institutions in a holding company system?

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[3] The poetically inclined might compare ILCs and banks to aspen trees, whose leaves turn color at the same time, because they are connected at the roots.

The Report gives a generally fair and thorough account of the arguments on various sides of these important issues and is well worth reading for that reason alone. That said, two of the principal conclusions that the GAO Report suggests– that banking and commerce should *not* mix, and that large ILC holding companies should be regulated by the Federal Reserve or by a regulator with similar supervisory powers – are not conclusively demonstrated, although the Report furnishes ample material for reflection. It is hard to take issue with a third conclusion of the GAO's paper, namely that Congress should give careful consideration to these questions, rather than allowing them to be resolved through inaction.

Separation of Banking and Commerce It will be recalled that the issue of mixing banking and commerce was extensively debated in the deliberations leading to enactment of the Gramm-Leach-Bliley Act in 1999. Congress decided not to permit commercial companies to acquire insured depository institutions, nor to allow financial holding companies to engage in commercial activities, except to the limited extent permitted under merchant banking authority. Congressman Leach, for one, even thought that the law had "plugged the loophole" permitting some mixing of banking and commerce through the unitary thrift holding company. Somehow, however, the ILC exception to the Bank Holding Company Act escaped Congressional attention.

Arguments frequently advanced against mixing banking and commerce, and cited in the GAO Report include:

- affiliation of commercial entities with banks could spread the federal bank safety net to these commercial entities;
- credit allocation could be distorted if banks were affiliated with commercial firms, with unduly favorable loans to related companies, and denial of credit to their competitors; and

- allowing industrial/financial conglomerates would lead to excessive concentration of resources, with large companies wielding too much power.[4]

These concerns, while plausible in varying degrees, are not self-evident. It is not obvious, for example, why the risks of spreading the federal bank safety net beyond the bank itself, or of distortion of credit allocation decisions, are more worrisome and acute in the case of financial/industrial conglomerates than they are with respect to conglomerates comprised entirely of financial entities. Recent scandals demonstrate that there are ample opportunities for mischief, and serious financial losses, among related financial companies (which is not, of course, an argument that additional opportunities for chicanery are called for).

And, while "undue concentration of resources" is an adverse effect that the Federal Reserve is required to take into account when assessing the nonbanking activities of bank holding companies, it is not clear what the term means that is not adequately addressed by the mandates that the Board also consider possible anticompetitive effects, conflicts of interests, or unsound banking practices.[5] To be sure, it is sobering to contemplate that a certain Seattle-based behemoth whose products are essential to the smooth functioning of our fast-paced digital economy might require us to take out a home mortgage as a condition to obtaining its other offerings. That would be a high price to pay for a tall double skim latte in the morning. But the laws against illegal tying are

[4]The arguments have not changed since the debates preceding enactment of GLBA. See, e.g. *Financial Services Modernization: Hearings before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services*, 105th Cong., 1st Sess. 132-135 (1997) (statement of former Federal Reserve Chairman Paul Volcker).
[5] See 12 U.S.C. §1843(j)(2)(A).

supposed to deal with that sort of thing. Sections 23A and 23B of the Federal Reserve Act also apply to ILCs to the same extent as banks.

Perhaps the most persuasive argument against the mixing of banking and commerce is the counter-example provided by Japan and Germany. As Chairman Volcker pointed out in his 1997 testimony before the House Subcommittee on Financial Institutions and Consumer Credit, there is reason to believe that the extensive linkages between banks and industrial firms in both of those countries have constituted a drag on banks and industrial firms alike, not to mention the two countries' economies as a whole.[6] However, before deeming the case closed, it would be appropriate (although difficult) to tease out the influence of other factors that may have contributed to the less-than-dynamic economic performance of Germany and Japan. Cultural differences, including more sedate business mores, protective labor laws and different antitrust standards, have no doubt also played a role. The sheer number of financial institutions in the United States, and the bare-knuckle competition among them, makes it hard to imagine that the U.S. financial marketplace could be afflicted with a similar drag on competition and innovation as a result of permitting banking and commerce to mix.

In the final analysis, however, it might be argued that, if the separation of banking and commerce is the norm in the United States, the burden is on the supporters of an exception to this general rule to justify their position.

Need for a Consolidated Supervisor The GAO Report contains a thorough and detailed comparison of the supervisory authorities possessed, respectively, by the Federal Reserve, OTS and FDIC. The GAO, noting the FDIC's more limited authorities to take action against the parent of an insured institution and its affiliates, and to require reports

[6] See note 3, above.

and impose capital or support requirements on them, expresses skepticism as to the FDIC's ability to supervise effectively a large and complex ILC holding company, particularly in times of economic stress. The GAO's preference for consolidated supervision is consistent with international standards accepted by financial regulators of all the industrialized economies: consolidated, comprehensive supervision of banking conglomerates is among the core principles promulgated by the Basel Committee on Banking Supervision, and it is also required by the EU's Financial Conglomerates Directive.

Nevertheless, the GAO Report may understate somewhat the practical leverage that the FDIC possesses in dealing with a regulated entity, and therefore overemphasize the importance of the gaps in the agency's supervisory arsenal. The FDIC vigorously defends its "bank-centric" model of regulation in comments appended to the Report. Moreover, as noted in the Report, the FDIC could impose a consolidated supervisory regime on an ILC's holding company by agreement with the entity's parent, along the lines of the SEC's consensual "consolidated supervised entity" proposal and the New York State Banking Department's arrangement with respect to the industrial parent company of an Article XII Investment Company.

However, inasmuch as consolidated supervision is the norm for most of the banking industry, perhaps the burden of justifying "bank-centric" regulation, as with the banking/commerce question, should lie with the FDIC and its other proponents.

Recommendations to Congress The GAO Report notes that there are proposals pending to allow ILCs, along with other insured depository institutions, to offer NOW accounts to businesses (robbing the prohibition on transaction accounts of most of its relevance) and branch de novo across state lines, although some versions would limit these benefits to ILCs whose holding companies have mostly financial activities.[7]

There seems to be little doubt that, if enacted, these proposals would make ILCs even more bank-like and attractive as banking vehicles for nonfinancial acquirers, placing in even sharper relief the questions surrounding their unique status in the federal banking scheme. In light of that, the GAO Report recommends that Congress consider various options:

- eliminating the current exclusion for ILCs and their holding companies from consolidated supervision;
- granting the FDIC similar examination and enforcement authority as a consolidated supervisor;
- leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor;
- more broadly considering the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity significantly more than the holding companies of other types of financial institutions is warranted or whether other entities should be permitted to engage in this level of activity.

These suggestions seem worthy of Congressional consideration. As ILCs grow in importance, the case for thoughtfully considering whether their special status continues to be justified seems more compelling. And evenhanded legislation would be preferable to regulatory determinations that might apply only to one or two companies. Then again, to paraphrase H. "Rap" Brown, loopholes in U.S. banking laws are as American as cherry pie. It could be that the variety, innovativeness, competitiveness and all-round dynamism

[7] Congressman Leach, on the other hand, has proposed legislation that would require companies controlling ILCs to become financial holding companies, subject to all the laws and regulations applicable to FHCs. Mr. Leach's bill would grant the holding companies five years to conform their activities and investments to these requirements. See H.R. 3882, introduced on September 22, 2005 and referred to the Committee on Financial Services.

of our financial markets owe something to the fact that our financial regulatory system is still something of a crazy quilt, with many odd-shaped patches and quite a few holes.

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