CATO INSTITUTE | Center for Monetary and Financial Alternatives

June 2nd, 2020

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC, 20429

Re: Parent Companies of Industrial Banks and Industrial Loan Companies, RIN 3064-AF31, 12 CFR 354

To Whom It May Concern:

I appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC) Notice of Proposed Rulemaking for Parent Companies of Industrial Banks and Industrial Loan Companies (Proposed Rule).

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato's Center for Monetary and Financial Alternatives, of which I am an associate director, is dedicated to revealing the shortcomings of today's centralized, bureaucratic, and discretionary monetary and financial regulatory systems and to identifying, studying, and promoting alternatives more conducive to a stable, flourishing, and free society.

I congratulate Chairman McWilliams and the FDIC Board for their efforts to make explicit the criteria that the FDIC will follow when deciding whether to approve industrial bank applications.

Summary

Industrial banks are a small part of the U.S. banking system, but theirs is the only class of charter that allows a non-financial company to own a bank. This exceptional status has made them unpopular with ordinary banks and some public officials. Yet industrial banks have historically performed well compared with other depository institutions, as they have been less likely to fail and tended to hold comparably large amounts of capital.

The Proposed Rule would require future industrial bank applicants to enter into one or more written agreements with the FDIC before they can secure its approval. These agreements would include several commitments by the applicant, including the commitment to consent to regular

FDIC examination, furnish the FDIC with regular reports regarding the applicant's and its subsidiaries' activities, and maintain the industrial bank's capital and liquidity at levels the FDIC deems appropriate. Making approval conditional on such agreements is a longstanding FDIC practice with respect to industrial banks, but a formal rulemaking will make the application process more transparent. Such transparency is likely to increase competition in financial services provision, to the benefit of consumers, with no extra risk to the deposit insurance fund.

The Current State of Industrial Banks and Opposition to Them

Industrial banks are FDIC-insured, state-chartered depository institutions that offer a more limited range of financial services than ordinary commercial banks. The 23 chartered industrial banks in operation as of the Proposed Rule's release date are a small but not insignificant part of the U.S. banking system, accounting for 0.44 percent of FDIC-insured depository institutions and 0.81 percent of FDIC-insured assets at the end of 2019.[1] While five states are currently home to industrial banks, Utah-chartered institutions held 94 percent of industrial bank assets, with Nevada-chartered ones accounting for another 5 percent, as of 2018.[2] All recent industrial bank applications have been for institutions that propose to locate in either Utah or Nevada.[3]

But industrial bank charters are significant beyond the small market share of the institutions that hold them, because they alone make it possible for non-financial firms to own banks. Since the passage of the Bank Holding Company Act (BHCA) in 1956, federal law has increasingly restricted non-financial firms' ability to hold controlling stakes in banks, and vice versa.[4] But the BHCA exempts industrial banks from the definition of a "bank," so long as they do not take demand deposits, hold less than $100 million in assets, or have not substantially changed their ownership or activities since 1987.[5] If an industrial bank meets any of these conditions, a non-financial company may own it.

Industrial banks' exceptional status has made them objects of controversy, particularly when large non-financial firms have applied or considered applying for this charter. Wal-Mart's application in 2005 elicited nearly 14,000 mostly critical comment letters, along with the opposition of some public officials and interest groups.[6] More recently, e-commerce firm Rakuten's application, since withdrawn, prompted vigorous opposition from bankers.[7]

Historically, banking industry arguments against allowing non-financial firms to own industrial bank subsidiaries have rested on appeals to the legal separation of banking and "commerce," the supposedly unique risk that these banks present to the deposit insurance fund (DIF), and the

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[1] Proposed Rule, p. 17780, and FDIC Quarterly Banking Profile, Fourth Quarter 2019, p. 5.
[2] James R. Barth and Yanfei Sun, "A New Look at the Performance of Industrial Loan Corporations," Utah Center for Financial Services, University of Utah (January 2018), p. 13.
[3] FDIC, Summary of New Deposit Insurance Application Activities. Accessed May 26, 2020.
[4] 12 U.S. Code § 1843.
[5] 12 U.S. Code § 1841(c)(2)(H).
[6] Proposed Rule, p. 17774, and Michelle Clark Neely, "Industrial Loan Companies Come Out of the Shadows," Regional Economist, Federal Reserve Bank of St. Louis (July 2007).
[7] American Bankers Association and Bank Policy Institute, Joint Comment Letter Opposing Rakuten ILC Application, August 30, 2019.

threat that large commercial-financial combinations might pose to competition.[8] A more recent argument has been that commercially owned industrial banks might exploit data-sharing provisions of existing banking law, meant exclusively for ordinary banks, to the detriment of consumers and competition.[9] Public officials, including some regulators, have also argued that the exemptions industrial banks enjoy "undermin[e] the prudential framework that Congress has carefully crafted."[10]

Notwithstanding such claims, industrial banks have historically performed well in comparison with ordinary banks. They have not failed more frequently than FDIC-insured commercial banks and thrifts. Most industrial bank failures occurred soon after they came under FDIC supervision in 1982, a time during which many more ordinary banks and thrifts failed.[11] In the last financial crisis only two small industrial banks failed, representing a smaller share of total industrial bank assets than the ratio of failed to total assets for FDIC-insured institutions as a whole.[12] Industrial banks also tend to have relatively high leverage ratios:[13] Financially-owned ones have maintained consistently higher leverage ratios than ordinary banks, while commercially-owned industrial banks maintained similar ratios to ordinary banks in the crisis years but have since substantially increased them.[14]

The FDIC's Statutory Role in Industrial Bank Applications

Opponents of allowing non-financial firms to own industrial banks claim that it is contrary to the BHCA's separation of banking and commerce, and to the spirit of U.S. banking law.[15] But current law explicitly exempts industrial banks from the BHCA, leaving no doubt as to legislators' intent to allow non-financial firms to secure these charters, subject to certain conditions.[16] In any case, the FDIC's role in considering industrial bank applications is not to ascertain whether they might jeopardize the separation of banking and commerce, but to consider only those factors enumerated in the Federal Deposit Insurance Act (FDIA). Those are: an applicant institution's financial history and condition; the adequacy of its capital structure; its future earnings prospects; the general character and fitness of its management; any risk it might present to the DIF; the convenience and needs of the community it plans to serve; and whether its corporate powers are consistent with the FDIA's purpose.[17]

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[8] Neely, "ILCs Come Out of the Shadows."
[9] ABA and BPI, Joint Comment Letter, p. 5.
[10] Alan Greenspan, Letter to Rep. Jim Leach, Jan. 20, 2006.
[11] Mindy West, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective," Supervisory Insights, Federal Deposit Insurance Corporation (2004).
[12] FDIC, "Bank Failures in Brief – Summary 2001 Through 2020." Accessed May 27, 2020.
[13] Government Accountability Office, "Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions," GAO-12-160 (January 2012), pp. 23-24.
[14] Barth and Sun, "A New Look at the Performance of ILCs," p. 19.
[15] Independent Community Bankers of America, "Industrial Loan Companies: Closing the Loophole to Avert Consumer and Systemic Harm," March 2019, pp. 6-9.
[16] 12 U.S. Code § 1841(c)(2)(H).
[17] 12 U.S. Code § 1816.

In general, the FDIC should approve any applicant that is likely to operate in a safe and sound manner, while serving the convenience and needs of its community. Although many recent developments in U.S. banking, notably consolidation and the growth of digital financial services, may call into question the fitness of existing federal banking law, the FDIC should not be called upon to settle such a matter. As Chairman McWilliams recently remarked, the FDIC's job is "to implement the law as it exists today."[18]

The FDIC's Proposed Rule

The Proposed Rule would require an industrial bank applicant to enter into one or more written agreements with the FDIC and its subsidiary bank as a condition for gaining the FDIC's approval.[19] Among other things, an applicant would commit to submitting and regularly updating a list of its subsidiaries and to reporting on its operations and activities; consent to FDIC examinations and independent audits; commit to limiting its representation on the bank's board to 25 percent of its membership; and commit to maintaining the bank's capital and liquidity at such levels as the FDIC deems appropriate.[20]

The commitments listed in the Proposed Rule are ones the FDIC has in the past required of individual industrial bank applicants. But there is currently no formal rule laying out the FDIC's approval and supervision policy. The FDIC believes that codifying these commitments will "provide transparency to current and potential industrial banks, the companies that control them, and the general public."[21] In this way, the Proposed Rule will make it less likely for objections unrelated to the FDIC's statutory obligations to slow down applications, especially those by non-financial firms. Prospective applicants will also be better able to assess whether an industrial bank charter is right for them if they know in advance the standards they will be held to.

Ensuring a Level Playing Field for Industrial Banks

While the Proposed Rule would set forth minimum commitments required of industrial bank applicants, it would not prevent the FDIC from making additional demands as a condition for approval. Historically, the FDIC has tended to impose stricter prudential standards on industrial banks than on ordinary banks and thrifts.[22] The two most recent industrial bank approval orders continue this tradition. Specifically, the FDIC set a leverage ratio of 20 percent for Square Financial and 12 percent for Nelnet Bank,[23] whereas the statutory leverage ratio for ordinary

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[18] Statement by FDIC Chairman Jelena McWilliams on the Notice of Proposed Rulemaking: Parent Companies of Industrial Banks and Industrial Loan Companies, FDIC Board Meeting, March 17, 2020, p. 2.
[19] Proposed Rule, p. 17778.
[20] Ibid., p. 17786.
[21] Ibid., p. 17778
[22] Statement by Chairman McWilliams, p. 1.
[23] FDIC, Re: Square Financial Services, Inc., Order, March 17, 2020, p. 1; FDIC, Re: Nelnet Bank, Order, p. 1.

banks of similar size is 9 percent,[24] although the CARES Act recently lowered it to 8 percent for a limited period of time.[25]

While the facts and circumstances of industrial banks may sometimes call for supplementary prudential requirements, the FDIC should not put them at a competitive disadvantage by asking for more than it would of ordinary banks in a similar position. The Proposed Rule states that the required commitments "are intended to establish a level of information reporting and parent company obligations similar to that which would be in place if the Covered Company were subject to Federal consolidated supervision."[26] But, when deciding on future requirements, the FDIC should take into account other existing restrictions on industrial banks and their parents, such as the statutory limits on loans to affiliates, that are designed to reduce risks to the DIF.[27]

Section 38A of the Federal Deposit Insurance Act calls for the FDIC to make sure that a parent can act as a "source of financial strength" should its industrial bank experience financial distress.[28] While it is understood that the intent of the Proposed Rule is to continue to comply with that mandate, the FDIC should avoid a situation in which industrial banks face a heavier regulatory burden than other banks and thrifts, despite posing no greater risk to the DIF. This would render its policy unduly arbitrary and hinder entry into banking for no reason. The FDIC can help to avoid such an outcome by publicly disclosing its reasons for subjecting any industrial bank or its parent to more than the usual prudential requirements.

Impact on Bank Charter Applications

The FDIC anticipates a long-run average of four industrial bank applications annually: three for deposit insurance and one for change in control.[29] But it may be that the Proposed Rule, by introducing greater transparency and predictability into the industrial bank approval process, will encourage more firms to apply. Might it even make this charter more attractive than ordinary bank charters?

While industrial bank charters offer some advantages, especially to non-financial firms, federal banking law places important limits on the services that these banks may offer, unless they cap their assets at $100 million. Their prudential requirements also tend to be stricter, and, being state-chartered banks, they do not benefit from the protections national banks enjoy, such as federal preemption of state regulations.[30] Finally, their small number and share of banking system assets mean industrial banks lack the clout with officials and the general public that other financial institutions, notably community banks and credit unions, enjoy. It is therefore

[24] FDIC, "Community Bank Leverage Ratio Framework," Financial Institution Letters FIL-66-2019, November 4, 2019.
[25] H.R. 748 – CARES Act, 116th Congress (2019-2020), Sec. 4012.
[26] Proposed Rule, p. 17778.
[27] 12 U.S. Code § 371c.
[28] 12. U.S. Code § 1831o–1(b).
[29] Proposed Rule, p. 17782.
[30] Office of the Comptroller of the Currency, "National Banks and the Dual Banking System," September 2003, pp. 10-11 and 21-25.

unlikely that the Proposed Rule will awaken interest in an industrial bank charter among those eligible for an ordinary charter. Instead it will encourage firms to enter the banking business that would not be inclined to do so otherwise.

Conclusion

The Proposed Rule introduces welcome transparency into the FDIC's industrial bank approval process. By making explicit the commitments that an applicant must make, the Proposed Rule stands to increase entry into banking and competition in financial services provision, without presenting additional risks to the DIF. With millions of U.S. households still lacking access to even basic banking services,[31] and after years of historically few *de novo* bank charters, the Proposed Rule is a step in the right direction.

Thank you for the opportunity to comment on this important issue. I would be happy to answer any questions you may have at DZuluaga@cato.org.

Sincerely,

[redacted]

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[31] FDIC, "2017 FDIC National Survey of Unbanked and Underbanked Households," Full Report (October 2018), p. 1.