Industrial Loan Companies After The Moratorium

Friday, Feb 01, 2008 --- The FDIC’s self-imposed moratorium on industrial loan company (ILC) applications expired yesterday. The expiration marks the end of a contentious two year period in which Congress, federal banking agencies, and the private sector vigorously debated the future of these specialized banking entities. Industrial loan companies are state-chartered, FDIC insured financial institutions that are not subject to the Bank Holding Company Act’s restrictions.

Commercial corporations not subject to the oversight of a federal banking regulator can own industrial loan companies and use them to perform a variety of banking services for the parent corporation.

Critics fear that this commingling of commerce and banking threatens the deposit insurance fund and the safety and soundness of the ILC.

Despite congressional efforts over the past two years to tighten the restrictions on industrial loan company ownership, the current regulatory landscape remains largely unchanged from the state it was in before the FDIC agreed to halt processing ILC applications.

On July 28, 2006, the FDIC imposed a six month moratorium on applications for deposit insurance for new industrial loan companies and applications to acquire existing industrial loan companies.

The moratorium was motivated, in part, by Wal-Mart's application for an ILC charter and the political backlash that ensued. A year before, Wal-Mart, like Target, Pitney Bowes, BMW and other commercial corporations before it, filed an application for FDIC insurance for an industrial loan company.

Unlike these other commercial corporations, whose ILC applications were approved by the FDIC with little controversy, Wal-Mart’s ILC application was met with stiff resistance from federal and state politicians, community banks, and consumer advocates.

Even though Wal-Mart’s application stated that the ILC would be used only to perform payment processing services, critics were unconvinced of the FDIC’s ability to prevent Wal-Mart from establishing or Wal-Mart’s promises to refrain from establishing Wal-Mart bank branches across the country once their application was approved.

The FDIC held public hearings to discuss Wal-Mart’s application, industrial loan companies, and the greater issue of keeping commerce separate from banking.
The overwhelming majority of participants at the public hearings urged the FDIC to deny Wal-Mart’s application and called on Congress to “close the ILC loophole” by subjecting ILC owners to bank holding company treatment.

While politicians, the public, and the FDIC were considering the merits and demerits of Wal-Mart’s application, retailer Home Depot filed its own application on June 28, 2006 to acquire an existing industrial loan company, EnerBank. Home Depot intended to use the ILC to facilitate home improvement loan processing.

At the time Wal-Mart and Home Depot’s applications were pending, the FDIC considered seven criteria to decide whether to approve an application for deposit insurance.

Under those criteria, which include the institution’s financial history, capital structure, proposed management’s character and fitness, and considering only the purposes Wal-Mart and Home Depot stated in their applications, it appeared as though the FDIC would approve the applications.

However, pressure from Congress, most notably House Financial Services Committee Chairman Rep. Barney Frank (D-MA) and the late Representative Paul Gillmor (R-OH), and the general public convinced the FDIC to issue a moratorium on all ILC applications.

Although recognizing that the FDIC’s statutory oversight of ILCs had proven adequate thus far, the FDIC imposed the moratorium to evaluate whether statutory changes should be made to protect the insurance fund and to further other congressional objectives.

The FDIC issued the moratorium to give Congress the opportunity to pass legislation that would directly close the ILC loophole, thereby foreclosing Wal-Mart and Home Depot’s applications.

The first moratorium halted all FDIC action on ILC applications for deposit insurance and change of control notices to acquire ILCs. The moratorium was to run from July 28, 2006 until Jan. 31, 2007.

During much of the first moratorium, there were no indicators that Congress or the FDIC intended to change the regulatory approach to industrial loan companies.

Then, with only three days remaining until the moratorium expired, Representatives Frank and Gillmor introduced H.R. 698, the Industrial Bank Holding Company Act of 2007.

The Act would prevent industrial loan companies from being controlled, directly or indirectly, by commercial firms, defined as entities that receive at least 15 percent of their gross revenue from activities that are neither financial in nature or incidental to a financial activity.
Sensing the undercurrents of legislative change, the FDIC took two measures based on the Frank-Gillmor bill.

First, the FDIC extended the moratorium on ILC applications for an additional year, but only with respect to applications filed by companies engaged in non-financial (commercial) activities.

Second, the FDIC published for comment proposed rules that would impose conditions and requirements on the acquisition of an ILC by companies that were (1) engaged solely in financial activities (or activities “complementary to financial activities”) and (2) not subject to consolidated bank supervision by the Federal Reserve or Office of Thrift Supervision.

The combined result of these two measures was to effectively close the ILC loophole for the upcoming year. Companies engaged in commercial activities were preempted by the second moratorium from filing industrial loan company applications.

In addition, with passage of the Frank-Gillmor bill looming in the background, it did not appear as though companies engaged in commercial activities would ever again have the chance to control an ILC.

Consequently, Wal-Mart withdrew its ILC application from the FDIC on March 16, 2007. Companies engaged in financial activities, however, could proceed with ILC applications as long as they were willing to consent to the FDIC’s proposed regulations.

Indeed, health insurer Well-Point filed an ILC application with the FDIC, who, after consulting with the Federal Reserve on the meaning of “complementary to financial activity,” approved the company’s application on the condition that Well-Point consent to the proposed regulations.

The FDIC’s proposed regulations require that companies engaged solely in financial activities and not subject to consolidated bank supervision must enter into a written agreement with the FDIC before acquiring an existing industrial loan company or establishing a new industrial loan company.

The written agreement commits the parent company to, among other things, consenting to examination by the FDIC, engaging only in financial activities, submitting to the FDIC an annual report of operations, and limiting its representation on the ILC’s board of directors to no more than 25%.

The proposed regulations also restrict the ILC from making a material change to its business plan, altering the composition of the board of directors, or entering into service contracts with the parent company without the FDIC’s prior written approval.

The regulations ensured that, going forward, each and every parent of an industrial loan company would be regulated by a federal banking agency,
assuming the Frank-Gillmor bill was enacted into law.

The Frank-Gillmor bill was passed in the House by a vote of 371-16 on May 21, 2007. The committee hearing on the bill proceeded in much the same way as the FDIC’s public hearings on Wal-Mart’s ILC application, with the debate generally focused on the separation of commerce from banking and the risks industrial loan companies pose to the insurance fund.

The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs on May 22, 2007 and since then, has never been heard from or seen again.

Nonetheless, the Senate has been active in discussing ILCs. On Oct. 4, 2007, the Senate Committee on Banking held a hearing devoted to examining the regulation and supervision of industrial loan companies.

At the hearing, testimony in opposition to industrial loan companies from, among others, ranking committee member Senator Christopher J. Dodd (D-CT), Federal Reserve General Counsel Scott G. Alvarez, and President and CEO of the American Bankers Association Edward Yingling signaled that enthusiasm for ILC legislation remained high. John F. Bovenzi, COO and Deputy to the Chairman of the FDIC, testified that, at the time of the hearing, there were four ILC applications for deposit insurance and three change of control notices for ILCs pending.

Even though demand for industrial loan companies remained constant over the course of the second moratorium and an apparent consensus existed in Congress to pass ILC legislation, the Senate Banking committee has not originated its own bill.

On Nov. 30, Senator Dodd circulated a “discussion draft” of an industrial loan company bill that would prohibit companies engaged in non-financial activities from controlling industrial loan companies.

Other than this draft, which has not been engrossed as a formal bill, the last and only sign that industrial loan companies remain on the legislative agenda was a statement by Senator Dodd in a Jan. 28, 2008 press conference in which he stated that he hoped to move ILC legislation in the next few weeks. So what is the present state of industrial loan companies post-moratorium?

Another moratorium is unlikely. Before the moratorium expired, Sheila Bair stated that the FDIC would not extend the moratorium a third time and would recommence processing ILC applications. However, Ms. Bair also stated that the FDIC would give Congress “a little wiggle room” to pass ILC legislation after the moratorium expired.

Currently, the only restrictions on industrial loan company ownership and control are those imposed by the FDIC’s proposed regulations. Companies engaged solely in financial activities that are not subject to consolidated bank supervision from the Federal Reserve or OTS that acquire industrial loan
companies will most likely have to consent to the FDIC’s proposed regulations.

The proposed regulations apply only to companies that are solely engaged in financial activities. Therefore, organizations seeking industrial loan companies are likely to argue that they are not so engaged.

Because the definition of “financial activities” was interpreted restrictively during the second moratorium as a way of preventing commercial companies from establishing or acquiring industrial loan companies, organizations now looking to avoid the proposed regulations can presumably do so with greater ease.

On the legislative front, the momentum to adopt ILC legislation has always been directly proportionate to the notoriety of companies interested in creating or acquiring an industrial loan company. Only after Wal-Mart filed an application for an industrial loan company was the issue ushered to the forefront of political discussion.

When Wal-Mart withdrew its application, it also withdrew a sizable portion of the immediacy to pass legislation. Of the seven applications that were pending as of the Oct. 4, 2007 Senate Banking committee hearing, only four remain. The JC Flowers’ proposed acquisition of Sallie Mae fell apart in December.

Home Depot withdrew its change of control notice to acquire EnerBank on Jan. 24, 2008. Finally, Blackstone Group’s change of control notice for Alliance Data’s industrial loan company will most likely remain pending as the two parties litigate over Alliance Data’s other bank, a national credit card bank.

With the departure of these three, high-profile applications, opponents of industrial loan companies have less ammunition to make their case that the ILC loophole must be closed.

Given the many economic issues the Senate must face in the weeks ahead, lawmakers would have to prioritize industrial loan companies very highly to enact legislation that would have the effect of preventing the FDIC from approving applications.

Without legislation, companies engaged in commercial activities are free to file applications to establish and acquire industrial loan companies, just as Wal-Mart did two years ago.

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