More of Their Ilk?
Policy Issues Raised by Industrial Loan Companies

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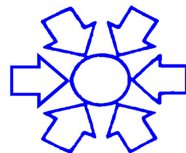

As usual, the GAO has taken on – or, to be more accurate, been handed – one of the tough questions in financial industry regulation. I appreciate the opportunity to participate in careful consideration of industrial loan companies (ILCs). As I understand it, the question is: can this genie be put back in its bottle? I know why the Federal Reserve would like to do so but, as I shall discuss in more detail, I don't think it can be done.

ILCs themselves are a grandfathered charter, just like unitary S&Ls. Without taking on the second – which permits big commercial firms to own insured savings associations – I don't see the point of taking on ILCs – which permit big commercial firms to own insured state-chartered banks. Since I don't think anything can or will be done about unitary thrifts, I suggest it is a better use of supervisory resources to figure out how to govern insured depositories owned by commercial firms, not try now to wrestle a genie that, squirming madly, will find ways to pop out of any bottle Congress might be willing to build.

I take this position largely based on long-standing faith in industry creativity. As has been demonstrated time and time again, anyone who wants in to the financial services industry can find a way. All that Congress is able to do – also demonstrated over and over again – is to shut barn doors long past horse departures, grandfathering innovative enterprises even if slow-pokes are barred from emulating them. This has created a patchwork of tremendous inconsistency that is often troubling, but the patchwork points to the problems of devising safety-and-soundness regimes based on charter selection or, worse, denial.

I'm at a loss, for example, to fathom why an ILC owned by Wal-Mart is riskier on its face than a savings association owned by Nordstrom. Why does an ILC owned by BMW scare us more than a savings association owned by GM? Are there inherent differences between an ILC charter and a thrift? I don't think so – each, for example, can be owned by a holding company over which the regulator has little control. Are ILCs that take NOW accounts – now allowed – less risky than they would be if empowered to take demand deposits? Can consumers tell the difference, or is it just the couple of extra basis points in cheap core deposits – and the competitive impact they would have – that is driving the ILC debate? Is a $40 billion ILC owned by Merrill Lynch and regulated by the FDIC and the states riskier than the $105 billion BB&T one under a comparable regulatory regime? All I know that divides the two is the fact that BB&T is also a financial holding company, and I'm not sure this is the cure-all some suggest.

And, what about the new SEC charters: supervised investment bank holding companies and consolidated supervised entities? These firms can own ILCs, savings associations and lots of other charters that are indistinguishable to the naked eye from a traditional insured depository. Are they more or less risky than a big commercial bank affiliated with a big investment bank in a financial holding company under the Fed's purview?

As you can perhaps tell, I think a lot of these questions split hairs based on whom we want in the financial services industry or who wants to regulate those allowed in. These are not, I think, lasting structural differences with real safety-and-soundness impact. If it's essential for a good regulator of an insured depository also to have a holding company over which the Fed has authority, then let's take a very deep breath and do that for all. If it isn't actually the Fed that's the issue, but inter-affiliate transaction risk, then let's address that and wall off the insured depository. Corporate governance? Let's follow through on suggestions from a while ago that the insured depository board be insulated from the parent one and charged with necessary fiduciary duties for the banking system, and then let's back that up with meaningful enforcement as necessary.

Why ILCs and Not FHCs?

A threshold question when considering ILCs is why those owned by firms that could be financial holding companies (FHCs) aren't. The biggest ILC is owned by Merrill Lynch, a firm engaged to my knowledge in no line of business that would bar an FHC. Still, it doesn't want in, nor for that matter, do many firms making aggressive use of all sorts of limited-purpose banks.

What may lie at the heart of the ILC question – and much else in the future of the U.S. financial services industry – is the coming rewrite of risk-based capital (RBC) rules generally known as Basel II. U.S. law is strikingly different than elsewhere and the U.S. Basel implementation plan is also unique. As a result – in sharp contrast to the EU and most other nations – only a limited number of banks and savings associations controlled by entities under the Federal Reserve need come under Basel II. Others may elect to do so in the SEC's new regime, but their RBC framework will be markedly different from the one proposed by the banking agencies despite suggestions that all are "Basel II."

Basel II mandates its new RBC regime – and all of the supervisory standards accompanying it – at a "consolidated" level, which means that its rules will apply to bank parent companies, as well as banks. As noted, the U.S. plans to do this, but current law permits it only for financial holding companies. None of the U.S. banking agencies has the power to impose Basel on a non-BHC/FHC parent. This ensures that these non-banking entities use market, not regulatory capital – often a distinct advantage. The rationale in the EU for the consolidated approach is the lack of supervision and standards like Sections 23A and 23B. Absent a consolidated approach, risk is easily contagious from a non-bank affiliate to a banking one. U.S. regulators supported the Basel consolidated approach, and it underlies arguments for Fed ILC regulation. However, one should give careful consideration to whether bank capital standards are, in fact, appropriate for non-bank parents. They may be necessary in the EU – where, as noted, prudential regulation is often limited and examinations non-existent, but they can have far-reaching, undesirable effects if mandated in the U.S. Better, as suggested, to use all of our current remedies – buttressed as necessary – to insulate the insured depository from the rest of the enterprise and have done with where bank regulation starts and stops.

A counter to this argument is that a "silo" approach is wrong for large complex banking organizations. I don't entirely disagree with this – silos can topple on each other and leave all in ruins. However, absent a comprehensive rewrite of U.S. banking law – not in the cards, as far as I can tell – silos will remain even if ILCs are forced from theirs. Piecemeal reform creates potentially serious distortions that can be better addressed by broad review of safety-and-soundness standards applied to all companies in the same business regardless of parent company charter. Will this tell the Fed in advance of a big firm that, were it to go bust, could threaten monetary policy? No, but then neither will changing ILC rules. None of this would have caught LTCM, nor will it address Goldman Sachs or many other companies that could go bang in a big way. The Fed can and should monitor all large complex banking organizations with the formidable resources at its command, working for a cooperative relationship with functional regulators (now allowed in law) to keep tabs on those it fears.

A Pragmatic Concern

As the above discussion suggests, I'm not taking a position necessarily on whether ILCs do or don't pose undue threat, especially if owned by commercial firms. I'm saying first that current bank rules, especially the capital ones, are very difficult to apply to parent companies and, in many respects, this doesn't need to be done if supervision and governing rules are correctly crafted – largely possible, by the way, under current law.

But, I'd like to raise another point. Assume, for the moment, that Congress reaches the Fed's desired epiphany and shuts ILCs down for all but companies willing to become financial holding companies. Going even farther into the unlikely, assume also that the new law doesn't include the usual grandfather and requires either divestiture or an FHC structure for those who are eligible for it. This assumes, even further into the ether, that Congress also shuts down unitary thrifts owned by non-FHC eligible firms. Then what?

My guess is that companies looking to do some financial services will still find a way around the Fed as long as bank capital rules and other requirements are applied at the parent company level. FHC eligible ILC parents will become unitary thrifts, and commercial ones will exploit all the remaining avenues in law to get to their customers the financial services they think make sense. This can be done in lots of ways – finance companies are a traditional approach, for example. If payment-system access is needed or even insured deposits, then there's always the "rent-a-bank" approach – or, to be more dignified, "strategic partnerships."

In short, I think the best approach to ILCs is to define an effective regulatory structure for them that ensures that the insured depository is run the right way from a bank supervisory point of view and the rest of the parent enterprise continues more or less merrily on its way. Any other approach, I suspect, is doomed to failure because the industry will always innovate its way around roadblocks that Congress is unable to erect in truly formidable fashion.