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Industrial Loan Companies

by O. Emre Ergungor and James B. Thomson

Once Wal-Mart announced its intention to acquire an industrial loan company, a public furor arose that has brought a lot of attention to a type of institution that has existed for quite some time, but was not widely recognized outside of banking circles. What are ILCs and why have they become so controversial lately?

Industrial loan companies have been a part of the financial landscape for the better part of a century, but until recently, not many people outside of banking circles had heard of them. Much like early-twentieth-century building and loan associations, which filled a void in home loans left by mainstream financial institutions, industrial loan companies (ILCs) arose to fill a void in unsecured consumer lending.

When the first ILC came into existence in 1910, the way it conducted business—from its approach to consumer lending to the way it funded loans—was sufficiently different from traditional banks that it and the institutions that evolved from it were not considered to be banks from a legal standpoint. This legal distinction would keep ILCs exempt from certain types of bank regulation in later decades.

When commercial banks finally warmed up to the business of unsecured consumer lending in the 1920s and began to surpass the ILCs in the market in later decades, it seemed as though the ILC industry would be relegated to a footnote in financial history. The limited nature of the ILC charter placed these institutions at a competitive disadvantage to other consumer lenders in the market.

Yet not only have ILCs survived, they have begun to grow. At the end of 2004, there were 57 ILCs in existence with combined assets of $140 billion—up from $3.8 billion in 1987—and six of these ILCs ranked among the largest 180 financial institutions in the nation, according to a 2005 GAO report. The largest ILC has over $66 billion in assets, making it one of the top-25 commercial banking companies in the United States.

The marked increase in the size of the average ILC, the growth of industry's combined assets, and the recent well-publicized applications for ILC charters by large commercial firms suggest that these institutions are becoming more than niche players in financial markets. Below, we take a look at some reasons why.

A Short History of ILCs

ILCs emerged from the Morris Plan banks of the early twentieth century. The name "Morris Plan" comes from a Virginia lawyer, Arthur J. Morris, who in 1910 began providing loans to low- and moderate-income workers who had stable jobs but did not have access to credit from commercial banks.

Banks of the time were reluctant to lend to these workers because it was difficult for them to distinguish between workers who were likely to repay their loans and those who were not. Such a difficulty can lead to an *adverse selection problem*, where the only people asking for loans are the most risky sorts of borrowers. Riskier borrowers should pay a higher interest rate than less risky ones, but when bankers cannot distinguish between the two, they cannot set an interest rate that both compensates them for the risk they are taking on and is still acceptable to all borrowers, both high- and low-risk.

Adverse selection can lead to credit market failure if banks don't find a way to tell the types of potential borrowers apart. Commercial bankers at the time had found a partial solution to the problem by relying on the ability of workers to post collateral as a loan-screening device. Safe borrowers could post a large amount of collateral because they knew they would repay the loan and never lose the collateral. In return, the bank could charge them a low interest rate. High-risk borrowers, on the other hand, knew that they might very well lose their collateral, and they agreed to pay a high interest rate so they could post lower collateral.

But most low- and moderate-income workers did not have acceptable collateral, and as a result, they could not secure credit from a bank. Morris's ingenious solution to the adverse selection problem did not require collateral. Instead, he required the signature of two co-signers on a loan, chosen among the family and friends of the borrower. This business model was based on his now-conventional belief that pressure from friends and family would keep borrowers honest and make them repay their loans. At that time, however, it was unheard of.

ILCs created confusion about whether or not they were "banks" from day one. When Morris applied to the Virginia Corporation Commission for a charter for his institution, he got the following reply from the chairman of the Commission:

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Dear Arthur:

I have carefully considered your application for a charter for your hybrid and mongrel institution. Frankly, I don't know what it is. It isn't a savings bank; it isn't a state or national bank; it isn't a charity. It isn't anything I ever heard of before.

The way they made loans was the biggest difference between the ILCs and banks, but it wasn't the only one. State law prevented the ILCs from receiving deposits, but deposits were a good way for lenders to finance themselves. Morris's solution to this problem was to use deposits but to call them something different, in this case, "thrift certificates." Even 20 years later, thrift certificates were considered to be different from deposits—when the Federal Deposit Insurance Corporation (FDIC) was established in 1933, ILCs were excluded from deposit insurance because, well, they were not allowed to accept deposits.

The FDIC's decision confirmed the ILCs' quasi-bank status but also put them at a great disadvantage relative to commercial banks. Commercial banks in New York had begun to make small consumer loans in the mid-1920s, and after the Great Depression, these banks began to dominate consumer lending, the previous strength of the ILCs. Commercial banks could overtake the ILCs in this area mainly because they could offer various banking services, such as loans and, after 1933, *insured*-demand deposits under one roof. (Demand deposits are typical checking and savings accounts.)

Even without federally provided deposit insurance, the ILCs did not slide into oblivion. As they could not compete with banks in attracting demand deposits, they funded themselves with equity, ordinary debt, time-deposits, and NOW accounts (which allowed depositors to withdraw their funds with a seven-day advance notice).

This strategy turned out to be their salvation. In 1956 new legislation prohibited any affiliation between commercial entities and banks. And because banks are defined as financial institutions that make commercial loans *and* accept *demand* deposits, ILCs are not prohibited from such affiliations, a stroke of luck which created a new niche for these institutions. Because ILCs do not accept demand deposits, they are not considered banks, and they can have commercial affiliates. But while ILC deposits are not demand deposits, they have been FDIC-insured since 1982, and so the advantage that other types of banking institutions had over ILCs with respect to FDIC insurance has disappeared as well. Furthermore, ILCs are exempt from bank-holding company regulation, so companies that own an ILC avoid the regulation and supervision of agencies that oversee bank holding companies. ILCs quickly became the takeover targets of commercial entities and investment banks that wished to have limited banking powers but did not want to bear the burden of bank-holding-company regulation.

Over the next four decades, Congress passed a number of banking bills that further limited the ability of commercial firms to own federally insured depository institutions. Today, the ILC charter is effectively the only vehicle by which nonfinancial firms can enter banking, and by which nonbank financial firms can own a depository institution without being subject to holding-company supervision by the Federal Reserve System.

The Value of an ILC Charter

Commercial firms have acquired or established their own ILCs for various reasons. For example, Home Depot recently applied to acquire an ILC and intends to use it, according to a company spokesperson, to extend loans to contractors. According to the Independent Community Bankers of America, Merrill Lynch, which owns the largest ILC, uses its ILC as a depository for the cash balances of its investor clients, providing them with the option of holding some or all of their cash balances in FDIC-insured deposits. Toyota uses its ILC to offer financing to customers for car purchases. General Motors Corporation uses its to hold escrow deposits associated with its mortgage subsidiary, GMAC Mortgage Group. Target uses its ILC to issue credit cards to its corporate customers. Wal-Mart applied for an ILC charter in July 2005, and the reason it wants an ILC, according to the company's head of financial services, is so it can gain access to the system through which payments are processed and settled—one area of financial intermediation that remains the exclusive domain of depository institutions.

Such access would allow Wal-Mart to complete the final stage of a process that takes place when customers pay by credit card, debit card, or check—one perhaps few customers realize even exists—which involves the actual and irrevocable transfer of funds from the bank accounts of customers to the bank account of the merchant. Home Depot, Wal-Mart, or any other large retail establishment that owned an ILC could do the same.

In all these cases, commercial firms can potentially save a great deal of money by bringing banking services in-house rather than paying another institution for them. For instance, a retail or discount store might pay 2-3 percent of a credit card transaction to the credit card company. This 2-3 percent fee is divided among the bank issuing the credit card, the credit association, and what is known as the merchant acquirer—that is, the firm that processes the payment. Owning an ILC allows the store to bring in-house the processing of credit and debit card transactions if it can do so at a lower cost than what would be paid to the merchant acquirer. Given the fixed costs of establishing and operating a payment processing center, owning an ILC for payment processing purposes may make sense only for large companies, which accept a large number of payments during the ordinary course of business.

How much is access to the payments system worth? Quite a bit it would seem. In a pair of studies, Tara Rice investigated what commercial banks earn from their payments-related services and found that the top 40 banking companies in 2001 derived 16 percent of their operating revenue from payments-related activities and that there was a positive and significant relationship between the size and scope of a bank's payments-related activities and the value of the banking company. While it is difficult to sort out how much of a bank's payments-related income comes from the processing and settlement of credit and debit card transactions and checking account fees (as opposed to servicing mortgages or pro-

cessing securities trades), there is clear value to commercial firms of being able to offer products and services that they could not provide if they did not have access to the payments system.

■ The Future of ILCs

Even though there are potential gains associated with allowing commercial companies to bring some banking services in-house, there are potential problems with the unique status of the ILCs. Like all depository institutions, ILCs have access to the federal financial safety net: Their deposits are insured by the FDIC, the Federal Reserve guarantees the transfers of funds that they are allowed to make over its electronic network, and they can borrow money through the primary lending facilities of Federal Reserve Banks.

But unlike other institutions that have access to the federal financial safety net, ILCs are not subject to the same level of supervision, on account of their exemption from bank-holding-company regulations. With bank-holding companies, supervisory oversight, which is put in place to protect the taxpayers who ultimately pay for the safety net, applies not only to the depository institution but also to the parent company and all of its affiliates as well.

ILCs are supervised by the FDIC, but a commercial company that owns an ILC is not supervised by any financial regulator. The owner and its affiliates are subject to regulatory scrutiny only to the extent that they have a contractual relationship with the ILC. The FDIC cannot monitor the business practices of the commercial owner or its affiliates to reveal potential risks to the soundness of the entire group or the ILC. In contrast, federal regulators have greater control over bank-holding companies, including the authority to fire the management of a company in the holding structure or force divestiture of nonbank holding-company affiliates if the company policies are putting the soundness of the depository institution at risk.

The unique status of ILCs has recently become the subject of much attention, including a congressional hearing on ILCs on July 12 of this year. Some, including the former Federal Reserve System chairman Alan Greenspan, the current chairman Ben Bernanke, and Federal Reserve System General Counsel Scott Alvarez, have called for changes that would extend the regulations that apply to banks and bank-holding companies to the ILCs and the companies that own them. Others, including the acting general counsel of the FDIC, Douglas Jones, question the need to change the rules governing ILCs.

On July 18, 2006, the FDIC announced a six-month moratorium on applications for deposit insurance for industrial loan companies. The moratorium also prohibits changes in control of ILCs during the same period. The purpose of the moratorium is to allow public comment on a wide range of issues surrounding ILCs, "including the current legal and business framework of ILCs and the possible benefits, risks, and supervisory issues associated with ILCs." Policymakers and researchers can take the opportunity to continue to discuss the pros and cons of allowing ILCs to operate under the current rules or extending bank-holding-company regulation and supervision to them. At stake is not only the unique status of ILCs within the set of organizations that are, for all intents and purposes, bank-holding companies, but also the one means by which commercial enterprises can own banking institutions.

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