NAIB
National Association of Industrial Bankers

NEVADA BANKERS ASSOCIATION
INVESTING IN NEVADA TOGETHER

UTAH BANKERS ASSOCIATION

The Honorable Ed Perlmutter
Chairman
Subcommittee on Consumer Protection and Financial Institutions
Committee on Financial Services
United States House of Representatives

The Honorable Blaine Luetkemeyer
Ranking Member
Subcommittee on Consumer Protection and Financial Institutions
Committee on Financial Services
United States House of Representatives

April 14, 2021

Dear Chairman Perlmutter and Ranking Member Luetkemeyer:

The National Association of Industrial Bankers[1], the Utah Bankers Association[2] and the Nevada Bankers Association[3] appreciate the opportunity to submit this statement for the record of the Subcommittee on Consumer Protection and Financial Institutions hearing on "Banking Innovation or Regulatory Evasion? Exploring Trends in Financial Institution Charters."

## I. Introduction

We applaud the efforts of the Subcommittee to investigate the changing dynamics of financial services in America. It is important that Congress ensure that American businesses and families have access to basic financial services, but with robust consumer protections.

The Subcommittee is also to be commended for focusing on key issues regarding financial stability, risks, benefits, and market fairness in analyzing financial institution charters. These are important elements in protecting consumers while enhancing the strength of the American economy.

The discussion in the hearing is likely to include comments regarding Industrial Loan Corporations. Since these institutions became eligible for FDIC insurance in the 1980s, knowledgeable practitioners prefer the term "industrial banks" (IB) as a more accurate description of these entities.

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[1] First chartered in 1910, industrial banks operate under a number of titles – industrial banks, industrial loan banks, industrial loan corporations and thrift and loan companies. Industrial banks provide a broad array of products and services to customers and small businesses nationwide, including some of the most underserved segments of the U.S. economy. NAIB members are chartered in California, Nevada and Utah.

[2] The Utah Bankers Association is the professional and trade association for Utah's commercial banks, savings banks and industrial banks. Established in 1908, the UBA serves, represents and advocates the interests of its members, enhancing their ability to be preeminent providers of financial services.

[3] Nevada Bankers Association is the united voice of Nevada's diverse banking industry: our members are dedicated to providing the best financial products, services and resources to drive and support economic growth, job creation and prosperity throughout the state of Nevada.

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As you explore the opportunities and risks associated with innovation in the financial services sector, please note the following facts verified by decades of historical performance:

- **Industrial banks are the safest and soundest insured depository institutions in the country.**

- **Industrial banks are fully regulated like every other bank by federal and state regulators.**

- **Industrial banks have never posed a systemic risk to the nation's economy.**

We welcome the Subcommittee's exploration of the details of the industrial bank charter because members will discover that the industrial bank charter provides the perfect environment to facilitate innovation while protecting consumers and taxpayers against risk. We recognize that some voices will always resist new entrants and the competition they create, but new entrants and the innovation they bring benefit consumers, especially those who are currently underserved. We know this is an especially important priority for this Congress.

Congress and the federal banking agencies have thoroughly explored the operations and regulatory model of industrial banks. The last fifteen years have seen two moratoria and several studies, each of which has reached the conclusion your Subcommittee is likely to reach. Nevertheless, the forces aligned against new entrants continue to make the same arguments and call for delay, another moratorium, and more study.

We ask the Subcommittee to note that the information we provide is based upon quantitative sources such as FDIC call reports, premier academic analyses, and judgments of state regulators. We also recommend "A New Look at the Contribution and Performance of Industrial Loan Companies to the US Banking System" by James R. Barth and Yanfei Sun, Department of Finance, Auburn University, July 2017[4].

## II. Historical background

A century ago, a new financial industry was created with the purpose of providing loans to low- and moderate-income industrial workers who had stable jobs but little access to bank credit. Because these institutions had industrial workers as their primary customers, they have been known ever since as industrial loan companies or "industrial banks" (IB).

Throughout their existence, IBs have always been state-chartered or -licensed institutions that make loans and offer their customers deposits, investment certificates, or both. During the Great Depression, when banks were failing in large numbers, IBs became the leading providers of consumer credit to workers. (IBs reprised this role as an important source of credit during the recent financial crisis.)

IBs have evolved to become a modern financial industry offering a wide range of products and services to a diverse group of customers.

## III. IBs are an intentional creation of Congress

The IB exemption from the Bank Holding Company Act ("BHCA") was an intentional creation of Congress when it enacted the Competitive Equality Banking Act of 1987 (CEBA). This status was

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[4] http://industrialbankers.org/wp-content/uploads/2018/10/IB_REPORT_BARTH_2018.pdf

not a loophole or an accidental oversight. Congress made that decision in order to allow the continuing development of industrial banks, which were subject to regulatory oversight as banks but were owned by companies exempt from the BHCA's activity restrictions. In the 33 years since the enactment of CEBA, Congress has repeatedly visited and modified the regulatory structure for our nation's banks and chosen to leave the regulatory structure for IBs intact. Congressional intent in this area is clear. Gramm-Leach-Bliley, which ended commercial ownership of unitary thrift holding companies, left ILCs untouched. During negotiations over what became the Dodd-Frank Act, the Administration recommended removing the ILC exemption from the BHCA, but Congress chose not to do so.

## IV. IBs are among the safest, strongest financial institutions in the nation

For decades, FDIC call reports have consistently confirmed that IBs are well capitalized, safe, and strong. This FDIC data shows that in comparison to commercial banks, IBs are better capitalized and are generally more profitable. The Utah Department of Financial Institutions (in prior testimony before the Task Force on Financial Technology) stated, "the Department calculates an average Return on Average Assets ratio of 1.04 percent for FDIC-insured depositories, whereas industrial banks average 2.48 percent." These numbers are not just a snapshot in time; IBs have consistently outperformed other banks in both ROA and capital-to-assets ratios for the past 35 years.

During the Great Recession, all but one IB survived (most remained profitable). The Federal Reserve did require several entities to close the operations of the IBs they owned as a condition of receiving TARP funding. All of these IBs were sound prior to the closure—none required assistance.

One reason for this is the added support a diversified parent can provide to its IB subsidiary. Unlike almost all commercial banks, most IBs have ready access to all the capital they may ever need. This has been demonstrated many times. IB parents enter into contracts with the FDIC that require the parent to contribute additional capital whenever the FDIC believes it is needed. Remarkably, a bank holding company regulated by the Federal Reserve is not required to contribute capital to a subsidiary bank and almost all have little or no ability to raise capital in any event. This is due to restrictions in the Bank Holding Company Act that prohibit activities not closely related to banking that eliminate any benefit from a parent holding other assets. As a result, most bank holding companies are shells that cannot serve as a source of strength to its bank. In the industry today, only the largest bank holding companies (because of their established presence in capital markets) and the diversified parents of industrial banks have any real ability to serve as a source of strength to a bank.

Yet, despite the incontrovertible evidence, there are voices who continually claim that IBs present a threat to the FDIC banking system. Please note that these allegations are frequently made without any documentation. **There is no evidence that disputes the strength of the IB model.**

## V. IBs are highly regulated by federal and state regulators

The FDIC and state regulators have broad authority over both IBs and their parent companies to take any and all actions necessary to protect the bank, its depositors and the deposit insurance fund. The FDIC has frequently affirmed its authority to regulate the industrial banks and their transactions and relationships with their parents and affiliates.

First and foremost, the IBs are regulated by both their chartering state and the FDIC and must comply with all relevant safety and soundness regulations, and all consumer protection regulations.

Industrial Banks are regulated like every other FDIC-insured bank: subject to the Community Reinvestment Act (CRA), fair lending requirements, privacy laws, the full array of examinations, taxes, etc. The only difference is that an industrial bank parent and affiliates are regulated by the FDIC, instead of by the Federal Reserve, and can engage in other businesses separately from the bank. By every tangible measure, this regulatory approach has worked extremely well.

The FDIC's recent rulemaking to codify existing regulatory practices further highlights the agency's ample authority to ensure that the parent company of an IB, be it financial or commercial, does not pose a risk to the insured institution, the taxpayers or to the U.S. financial system. Both the state regulators and the FDIC have the authority to examine parents and affiliates for compliance with Federal Reserve Act Sections 23A and 23B and ensure that the IB and its parent interact in a safe and sound manner and that banking and commerce do not mix in any way that would produce an undesired impact on the economy or the community. They can also require that the parent serve as a source of strength to the bank should it become distressed. The regulators can examine the parent company's records and management of the IB as needed should concerns arise. Finally, as former FDIC Chairman Martin Gruenberg noted, the FDIC and the appropriate state banking regulator can limit the activities an IB can engage in with a parent or affiliate if they are concerned about those activities' impact on the institution.

Contrary to unfounded accusations made by some groups, the main reason a parent chooses an IB charter is because it is a diversified company that has opportunities to offer specialized financial services, in most cases to an established customer base. The Bank Holding Company Act did not envision these synergies and precludes the parent from pursuing a commercial bank charter because of the other businesses within the group. The main difference about regulation of IB parents and affiliates is that regulators do not regulate other business activities of a diverse group that are not relevant to the bank. The regulators do regulate the transactions and relationship between each IB and its affiliates, and have a broad array of authorities to ensure they are compliant and safe. The now more than 35-year history of modern IBs has proven the safety and effectiveness of this model. It is no exaggeration to say IBs are the safest and strongest banks insured by the FDIC.

Many critics also raise concerns about conflicts of interest between an IB and its affiliates but fail to understand how Sections 23A and 23B of the Federal Reserve Act—applicable to all industrial banks and their affiliates under provisions of the Federal Deposit Insurance Act—effectively prevent any such conflicts of interest. IBs operate as fully independent entities and can only engage in transactions with affiliates that benefit the bank.

The bottom line is that the FDIC demands the highest standards of operation and performance by industrial banks. The FDIC regularly and exhaustively examines industrial banks and parent companies. Assertions that industrial banks are not regulated by federal entities or somehow escape proper supervision are simply not true and many are intentionally misleading.

## VI. Industrial banks' prior scrutiny

For decades, Senate and House committees, subcommittees, and task forces have examined and analyzed industrial banks' performance, safety, commitment to consumer protection, regulatory supervision by federal state authorities, etc. No evidence or documentation has ever

been submitted during these activities that show undue systemic or operational risks or dispute the factual statements provided in this letter.

Indeed, pursuant to the Dodd-Frank Act, the United States Government Accountability Office (GAO) conducted a comprehensive review of IBs. In 2012, the GAO issued a report on "Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions," which did not recommend any changes to federal law regarding IBs.

## VII. Industrial banks do not pose a "systemic risk"

Twenty-seven IBs hold $180 billion in total assets, as compared to 5,831 other banking institutions. IBs are 0.4 percent of the total number of FDIC-insured institutions, or 1 percent of these institutions' total assets.

The industrial banks were the most stable banks insured by the FDIC during the recession. For more than 30 years, they have consistently been the best capitalized and most profitable banks in the nation. As a group, industrial banks proved safer and stronger during the recession than other banks. One small industrial bank that specialized in small business credit cards failed in 2010 due to heavy losses and business closures among its customers.

In contrast, 529 community banks failed between 2008 and 2015, each of which had a holding company regulated by the Federal Reserve. Further, a few of the largest commercial banks, also regulated by the Federal Reserve, would have failed without government assistance, which was given to them because they posed systemic risks. The systemically important financial institutions (SIFIs) did include some investment banks that had IB subsidiaries, but those industrial banks were sound and still operate today, except for one that voluntarily self-liquidated at no cost to the FDIC. In fact, industrial banks played no role whatsoever in causing the Great Recession. No industrial banks then or now originate or syndicate housing loans or have any other connection to housing finance, except for one IB that finances energy-related home improvements such as new windows.

## VIII. IBs are innovative partners

The IB model allows for innovative but safe products for American consumers. Fintechs and other financial services companies continually seek partnerships with IBs to provide these services. These are partnerships that should be encouraged by Congress. In all cases, the regulators require the IBs to treat all loans the same, even if those loans are sold. The IB is responsible for full legal compliance, through advertising to servicing to collections, regardless of whether it holds the loan.

Also, some innovative financial services companies may seek an IB charter. The rules promulgated by the FDIC and state authorities make this extremely difficult and require a number of commitments from the parent company. Our associations fully support such rigorous demands. The IB model has worked because it is heavily regulated and requires high levels of capitalization. Yet, they remain innovative and flexible.

Some "fintech" companies have considered applying for an IB charter. One such company, Square, was recently approved for an industrial bank charter and federal deposit insurance. It is important to understand that this represents an opportunity only for a company with well-developed products and services that is ready to comply with the broad range of standards and requirements applicable to all banks to help ensure they operate safely. Companies in the early stage of development do not qualify. For various reasons, including the restrictions in

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Sections 23A and 23B, mega technology companies such as Amazon cannot own a bank that offer loans and other financial services to customers of an affiliate. Such large tech companies can offer a full array of banking services to their customers (the activities critics say pose a systemic risk to the economy and banking industry) only by partnering with an independent bank. Many companies have such relationships with banks.

## IX. IBs benefit American consumers with safe innovative financial services

In summary, IBs are among the safest and soundest banks in the U.S. system, and they do not create systemic risk. What they do create is competition and innovation in the U.S. banking system. IBs are small, innovative, fully-regulated banks that help create and test new products for consumers and businesses.

Again, we appreciate the opportunity to submit this statement for the record and are grateful for the efforts of the Subcommittee members and staff. Please let us know if you have any questions or need additional information.

Sincerely,


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