INDUSTRIAL BANKS MYTHS EXPLAINED

One of the most difficult challenges industrial banks face in Washington is correcting the misinformation spread by critics, much of which is deliberately misleading. A good example is a recent article on industrial banks written by Arthur E. Wilmarth, Jr., of the George Washington University Law School. The following quotes the basic claims in this article and then provides the pertinent facts omitted by Mr. Wilmarth.

CLAIM *"ILCs have frequently failed in the past . . . Thirteen ILCs failed between 1982 and 1984. Two ILCs that were heavily engaged in subprime lending (Pacific Thrift and loan and Southern Pacific Bank) failed in 1999 and 2003."*

FACTS

- This is one of the most misleading statements in the article. The ILCs that failed in Utah between 1982 and 1984 were not insured or regulated by the FDIC or any other federal regulator. They were small, locally owned finance companies making higher risk loans than federally regulated banks. Some similar finance companies in California that received FDIC approval failed a short time after approval was granted. The two industrial banks that failed in 1999 and 2003 were the same type of high-risk finance companies based in California.
- What this ignores is the difference between an ILC and an industrial bank. ILCs were local finance companies mostly making higher risk loans that regular banks would not. The industrial banks based today in Utah and Nevada are FDIC regulated branchless banks offering specialized products and services to customers nationwide and are subject to all of the same standards, requirements and oversight as every other bank. In terms of business plans and risk profiles, ILCs and industrial banks are polar opposites.
- It is especially noteworthy that Mr. Wilmarth cites those failures but ignores the 529 commercial banks with parents regulated by the Federal Reserve that failed much more recently during the Great Recession. Industrial banks have experienced no significant problems with bank failures, conflicts of interest or legal compliance. The record of failures is clearly much higher for commercial banks than industrial banks and most compliance issues have involved commercial banks, not industrial banks. That provides compelling and undeniable proof of the sufficiency of the current laws and regulations to ensure the safe and sound operation of industrial banks. *That is why Congress has seen no need to repeal or amend the exemption for diversified parent companies from the Bank Holding Company Act.*

CLAIM Approval of two industrial bank applications in 2020 *". . . effectively reverse the FDIC's previous policy of barring acquisitions of ILCs by commercial firms*."

FACTS

- The FDIC has no policy of not approving applications by commercial companies. It has approved and insured industrial banks owned by many commercial companies. Currently, seven industrial banks have parents or affiliates engaged in commercial businesses. Several additional commercial companies (GM, GE, AT&T) owned industrial banks in the past. To date, no industrial bank owned by a commercial company has failed or caused any loss to the FDIC.
- The article says as a result of this policy, no industrial bank applications were approved from 2008 until 2020. In fact, the FDIC effectively stopped approving any new banks during that period. Between 2008 and 2015, the FDIC approved a total of four new banks nationwide. Prior to 2008, between 100 and 300 new banks were formed in the U.S. each year.

CLAIM *"Further acquisitions of ILCs by commercial firms would . . . undermine Congress's longstanding policy of separating banking and commerce . . ."*

FACTS

- This issue causes a lot of confusion. First, there is no literal mixing of banking and commerce. Banks everywhere, including industrial banks, are only allowed to engage in traditional banking activities. They cannot own or engage in other businesses such as retail sales or manufacturing. Under current law, an industrial bank can only offer financial products and services permitted for a national bank and is prohibited from offering commercial checking accounts.
- Parents and affiliates of industrial banks are exempt by statute from the Bank Holding Company Act. Congress enacted that exemption in 1987 and has found no reason to repeal the exemption in subsequent years.
- The "commerce and banking" debate actually centers on what other businesses a bank parent can own that operate separately from the bank. Those with multiple businesses will be described as diversified.
- There was no restriction on diversified companies owning a bank until 1956 when the Bank Holding Company Act was first enacted. That law was designed to stop chain banking, which was a holding company creating a functional branch system by owning multiple "unit banks" that were otherwise prohibited from branching in some states. The law was prompted by one case in which a large holding company bought so many banks that it achieved a near monopoly in some southwestern states. At that time, only large diversified, multi state holding companies had the resources to acquire local banks on the scale needed to achieve

market dominance. That is why the Bank Holding Company Act restricts activities of a holding company beyond those "closely related to banking."

CLAIM *"Further acquisitions of ILCs by commercial firms would . . . threaten to inflict large losses on the federal "safety net" for financial institutions during future systemic crises, and . . . pose grave dangers to the stability of our financial system and the health of our economy."*

FACTS

- Since they first started nearly 40 years ago, FDIC insured industrial banks have consistently been the best capitalized and financially strongest group of banks insured by the FDIC**.** No industrial bank owned by a commercial company has failed. During the Great Recession, industrial banks performed better than other banks. Most remained profitable and many grew as other banks shrank. During that same period 529 commercial banks with holding companies regulated by the Federal Reserve failed and required FDIC assistance and some of the largest banks that were too big to fail also required assistance. The record is literally the opposite of Mr. Wimarth's statement.
- As examples of risks to the economy Mr. Wilmarth cites parents of some industrial banks that required assistance during the Great Recession. This included Goldman Sachs, Morgan Stanley, CIT and GMAC. In fact, those companies received assistance from the Federal Reserve, not the FDIC, because they were SIFIs and too big to fail. Their industrial bank subsidiaries had nothing to do with the problems they were having and those parent companies would have received assistance regardless of whether they owned an industrial bank. Each of those industrial banks was healthy, neither needed nor received any federal assistance, and still operates today under a different charter. Conflating the problems of the parent as a risk to the FDIC is completely erroneous and misleading. In fact, the historical record proves the exact opposite of Mr. Wilmarth's claims.

CLAIM *"Further acquisitions of ILCs by commercial firms would create toxic conflicts of interest and would also pose serious threats to competition and consumer welfare."*

FACTS

- To support this claim Mr. Wilmarth must characterize Sections 23A and 23B of the Federal Reserve Act as ineffective, which they are not. He cites examples of the Federal Reserve giving exemptions to GMAC, for example. What he does not mention is that the grant of the exemption was conditioned on GMAC separating from GM and becoming an independent company, which it did and operates today as Ally Financial.
- He also glosses over the fact that all of these instances involved an express exemption given by the Federal Reserve. Exemptions are only granted if a party convinces the Fed that no conflict or undue risk will result from granting the exemption. To date, GMAC may be the only industrial bank to receive an exemption from Section 23A.

- Industrial Banks owned by commercial firms have been operating for decades without any such "toxic conflicts of interests." This is because of the FDIC's diligent application of existing bank regulations including Sections 23A and 23B.

CLAIM *"The FDIC's limited supervisory powers over parent companies and other affiliates of ILCs are plainly inadequate to prevent the systemic risks, conflicts of interest, and threats to competition and consumer welfare created by commercially-owned ILCs."*

FACTS

- The FDIC and state regulators have essentially the same regulatory authority over a parent and affiliates of an industrial bank as the Federal Reserve has over a bank holding company. The primary difference is that the FDIC and state regulators do not regulate parts of the corporate group that operate separately from the bank and have no relevance to the bank.
- The regulatory model for parents and affiliates of industrial banks emphasizes the bank's independence and insulation from any problems in the corporate group. This has worked well in multiple instances of a parent failing or reorganizing.
- Diversified parents of an industrial bank are obligated to provide additional capital and liquidity whenever needed. Unlike most bank holding companies, a diversified parent can provide support if needed because it holds assets apart from the bank.
- There is simply no historical evidence to support the claim that the FDIC is not capable of adequately supervising parents and affiliates of Industrial Banks. Surely if this were the case it would have become clearly evident during the recent financial crisis.

The facts and the historical record clearly establish that Industrial Banks have been successfully regulated by the FDIC and state regulators for more than three decades. Congress has studied this record and has come to the same conclusion in every instance. If the goal is to allow for innovation that will benefit consumers while protecting taxpayers against systemic risks, the record is abundantly clear that the Industrial Bank charter is the obvious solution, not the problem as Mr. Wilmarth erroneously suggests.

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