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September 27, 2021

The Honorable Ed Perlmutter
Chairman

Subcommittee on Consumer Protection
and Financial Institutions
Committee on Financial Services
US House of Representatives
Washington, D.C. 20515

The Honorable Blaine Luetkemeyer
Ranking Member

Subcommittee on Consumer Protection
and Financial Institutions
Committee on Financial Services
US House of Representatives
Washington, D.C. 20515

Dear Chairman Perlmutter and Ranking Member Luetkemeyer,

The National Association of Industrial Bankers[1] appreciates the opportunity to submit this statement for the record to the Subcommittee on Consumer Protection and Financial Institutions hearing on: The Future of Banking: How Consolidation, Nonbank Competition, and Technology are Reshaping the Banking System.

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.

We are also grateful when Industrial Loan Corporations (ILCs) are included in discussions for this hearing. The purpose of this statement is to provide key facts regarding ILCs for the Subcommittee to consider and to correct certain misleading arguments made by the detractors of ILCs.

At the outset, the most telling fact that merits repeating every time the subject of ILCs is raised is that the FDIC insured industrial banks in Utah and Nevada have for the past 35+ years been the best capitalized, most profitable, safest and soundest group of banks insured by the FDIC. This is fact, not hyperbole.

Nothing in the history of the industrial banks provides any basis to argue that they present a significant risk to the FDIC, the banking industry or the nation's economy. The position taken by certain trade associations is pure political posturing to stifle competition.

[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.

In this regard, we ask the Subcommittee to note the information we provide is based upon quantitative sources such as FDIC call reports, premier academic analysis and judgments of state regulators. We 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, January 2018.

We also believe a recent report regarding regulatory supervision of ILCs will be especially helpful to the Subcommittee. Source of Strength and Consolidated Supervision: A Comparative Assessment of Industrial Banks and Commercial Banks, James R. Barth and Yanfei Sun, July 2021.

II. ILCs are among the safest, strongest financial institutions in the nation

For decades, FDIC call reports have consistently confirmed ILCs are well capitalized, safe and strong. This FDIC data shows that in comparison to commercial banks, ILCs are better capitalized, have a higher return on assets (ROA), and are generally more profitable. The Utah Department of Financial Institutions emphasizes "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."[2]

These numbers are not just a snapshot in time; ILCs 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 ILC survived (most remained profitable). The Treasury Department did require several entities to close the operations of the ILC they owned as a condition of receiving TARP funding. All of these ILCs were sound prior to the closure - none required assistance.

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

III. ILCs are an intentional creation of Congress, not a loophole

The ILC 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 not 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 ILCs intact. Congressional intent in this area is clear. Gramm-Leach-Bliley, which ended commercial ownership of unitary thrift holding

[2] Statement for the record from the Utah Department of Financial Institutions to the Task Force on Financial Technology of the U.S. House Committee on Financial Services hearing on "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age" September 29, 2020.

companies, left ILCs untouched. During negotiations of what became the Dodd-Frank Act, the Administration recommended removing the ILC exemption from the BHCA, but Congress chose not to do so.

In the past roughly 40 years, the FDIC has imposed moratoriums on granting new ILC charters twice for the express purposes of allowing Congress to review whether it should change or repeal the exemption for ILC parents and affiliates from the Bank Holding Company Act. The moratorium specified in the Dodd-Frank Act also required the GAO to study the issue and report to Congress 18 months before the moratorium expired. Both times that a moratorium was enacted Congress chose not to remove the ILC exemption from the BHCA. This history clearly shows that the narrative from the joint trades is political posturing not based on any incident or reasoning that would warrant considering the issue again. How many times does Congress have to say no to changing the current law before the trades will stop demanding another moratorium? The legislative record demonstrates that ILCs are not a loophole, Congress intended to allow ILCs their unique status and has repeatedly affirmed it.

IV. ILCs are strong financial institutions and are not a threat to the FDIC or the financial system

In addition to being incredibly safe and sound, it has repeatedly been proven that ILCs do not create systemic risk for the U.S. financial system or the deposit insurance fund.

As noted in the acclaimed report by Dr. James Barth and Dr. Yanfei Sun,

> In the aggregate both the financially owned and commercially owned IBs have higher equity capital-to-asset ratios and better financial performance measures (i.e., ROAs, ROEs, and efficiency ratios) than the non-IB, FDIC-insured institutions. The better overall financial condition of the IBs is not restricted to the fourth quarter of 2020. ...the same situation existed for almost every year from 2000 to 2020, which includes the Great Recession... However, in terms of *serious* potential threats to the FDIC insurance fund and broader financial stability, consider that all 25 IBs have total assets of $183 billion, while the 4,976 non-IB, FDIC-insured institutions have total assets of $22 trillion, which is 118 times larger. Moreover, the total assets of all the non-IB, FDIC-insured institutions are 1,237 times larger than those of the commercially owned IBs.[3]

Of the $18.5 trillion in total banking assets ILCs account for only $261.6 billion, or less about 1.5% of total banking assets. Total ILC assets added together do not even represent a top 12 bank in the United States. Commercially-owned ILCs are an even smaller portion of total banking assets at only $15 billion, representing well less than 1% of total banking assets and combined have total assets less than any of the top 100 US banks. ILCs in no way pose any threat to the US banking system. The numbers speak for themselves.

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[3] Source of Strength and Consolidated Supervision: A Comparative Assessment of Industrial Banks and Commercial Banks James R. Barth and Yanfei Sun, July 2021.

V. ILCs are highly regulated by federal and state regulators

One of the most long-lived myths perpetuated by the anti-competition elements that oppose the ILC charter is that the FDIC does not have sufficient authority to regulate ILCs, their affiliates or their parent companies. As we have stated repeatedly, the FDIC has broad authority over both ILCs and their parent companies to take all actions necessary to protect the bank, its depositors and the deposit insurance fund. The FDIC has repeated many times that it has adequate authority to regulate the industrial banks and their transactions and relationship with their parents and affiliates. First and foremost, the ILC itself is regulated by both its chartering state and the FDIC. It must comply with all relevant safety and soundness regulations, and all consumer protection regulations. Regarding the supervision of an ILC's parent company, FDIC Chairman Martin Gruenberg stated in response to questions from the Senate Banking Committee clarified this comprehensive regulatory structure clearly:

> ...the FDIC has the authority to examine the affairs of any affiliate, including the parent and its subsidiaries, as may be needed to disclose the relationship between the ILC and the affiliate, and the affiliate's effect on the institution. And, similar to other insured institutions, the FDIC can prohibit an insured ILC from engaging in activities with an affiliate or any third party that may cause harm to the ILC. In the event supervisory concerns are noted, the FDIC may pursue the same enforcement powers authorized with respect to any other insured institutions.

The recent rulemaking by the FDIC to codify existing regulatory practices further highlights that the agency has ample authority to ensure that the parent company of an ILC, be it financial or commercial, does not pose a risk to the institution or to the U.S. financial system. Just a couple of examples of the authority both the state regulators and the FDIC have include examining for compliance with Federal Reserve Act Regulations 23A and 23B and ensuring that the ILC and its parent interact in a safe and sound manner. They can also require that the parent serve as a source of strength to the bank should it become distressed. They can examine the parent company's records and management of the ILC as needed should concerns arise. Finally, as former Chairman Gruenberg highlighted, the FDIC and the appropriate state banking regulator can limit the activities an ILC can engage in with a parent or affiliate if they are concerned about its impact on the institution.

VI. ILCs are not a privacy risk and comply with all federal and state laws

ILCs are regulated depository institutions that most comply with all consumer protection laws, including the Gramm-Leach-Bliley Act privacy requirements. They have the same obligation to safeguard consumer data, notify customers of how data is used, and provide opt-out opportunities as all other financial institutions. ILCs understand data protection is fundamental to every bank operation and as FDIC-insured depository institutions comply with the same state and federal laws and regulations surrounding information protection, including privacy, information security, physical security, business resilience, and cybersecurity requirements that apply equally to all FDIC- insured banks. Like all FDIC-insured depository institutions, ILCs comply with insider lending regulations, identity theft, fraud, the Bank Secrecy Act and anti-money laundering compliance requirements that protect our customers.

Furthermore, we agree that the parents of ILCs should not misuse bank customer data. Congress should deal with that so that all banks are required to safeguard customer data, not just ILCs.

The merging of technology and financial services does warrant a discussion about whether privacy laws need to be updated. We are happy to have that discussion. Our members believe in protecting their customers and their data.

VII. ILCs benefit American consumers with safe innovative financial services

ILCs 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. ILCs are small, innovative banks that help create and test new products for consumers and businesses. Some incumbent banks are looking to stifle this competition by asking Congress to restrict new charters for ILCs, which represent only 25 institutions and 1.4% of domestic banking assets. What do the incumbent banks have to fear outside of competition? Nothing. This request for restrictions is a simple effort to stifle competition and deprive consumers and businesses of choice.

We ask you to look at the facts, which make clear that ILCs are not a threat to the banking system, the U.S. economy, or consumers. They provide needed competition in a safe and regulated manner. Rather than trying to stop this, our nation's banks of all types and sizes should be calling for more successful leading-edge companies to explore a banking charter. Such inventive organizations applying for banking charters takes financial innovation from the fringes of the legal system into a space where that innovation can happen while being regulated for safety, soundness and consumer protection. Congress should fully support this effort.

VIII. The Proposed Legislation "Close the ILC Loophole Act" is confusing, anti-competitive, and unfair.

The legislation is based on a false premise.

The "Close the ILC Loophole Act" assumes that more regulation by the Federal Reserve of ILCs is needed, especially by removing the exemption from the Bank Holding Company Act. Supporters of the legislation have yet to document how the current regulatory structure is harmful to consumers or the economy. Indeed, the preceding pages of this statement demonstrate otherwise.

Drs. James R. Barth and Yanfei conducted an analysis of whether Federal Reserve supervision is superior in their July 2021 report.[4] These respected academics concluded:

[4] Source of Strength and Consolidated Supervision: A Comparative Assessment of Industrial Banks and Commercial Banks James R. Barth and Yanfei Sun, July 2021.

> Based on the examination of the difference, in terms of serving as a source of strength and consolidated supervision, between holding companies of [Industrial banks] IBs and holding companies of banks, we find that bank holding companies are not better positioned to be a source of strength than the holding companies of IBs. Nor do we find that IB holding companies are more likely to contribute to financial instability than bank holding companies. There is, therefore, no support for the argument that IB holding companies should be subjected, like bank holding companies, to consolidated supervision by the Federal Reserve. The bottom line is that the evidence presented indicates no corrective legislative action is needed to deal with industrial banks.

The legislation creates confusion.

The legislation would create three categories of industrial bank holding company regulation:

- ILCs approved prior to September 23, 2021 would be subject to reporting and examination by the Federal Reserve. The bill leaves unanswered a question about what the Federal Reserve would do with that information. The FDIC would presumably continue to have its current authority over "institution affiliated parties" to restrict or prohibit and punish any activities that do or may harm the bank.
- ILCs that applied for FDIC insurance before September 23, 2021 and were approved between then and September 23, 2023, would be required to provide reports and be examined by the Federal reserve, and could impose conditions on transactions between the bank and its parent and affiliates. This is basically the bank centric model currently applied to ILC parents and affiliates, but the Fed could potentially restrict more than is required by Sections 23A and 23B and could impose restrictions that would affect the value of the bank to the parent and corporate group.
- ILCs that apply for and receive FDIC approval after September 23, 2021 would not be exempt from the BHCA and would be regulated as a BHCA by the Federal Reserve.

Providing three different types of ILCs is both confusing and counterproductive. No documentation or support is provided as to why this is a superior structure to the current statutory scheme. Furthermore, it impedes the innovation and niche lending advantages available to the ILC charter.

The legislation is fixing something that is not broken.

This legislation compels the following questions: Why is it necessary or beneficial to subject ILC holding companies to Fed regulation? Where has there been an actual problem that shows flaws in the current system?

Better legislation would address actual existing legitimate concerns.

We understand that many in the financial services community care about all aspects of privacy, security, soundness and innovation for all banks, not just ILCs. Thus, we are willing to work with Subcommittee members and others for legislation that achieves important modifications to existing statutes. These include:

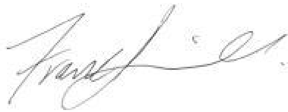
- Agree to support codification of the FDIC rule on holding company regulation especially reporting and examination.
- Support legal restrictions on information sharing. That will block big tech companies and other businesses that sell customer information as their primary business.
- Require the GAO to perform a study of the ability of big tech to own and operate any kind of bank. This debate will not make sense until Congress understands those limitations.

IX. ILCs benefit American consumers with safe innovative financial services

In summary, ILCs 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. ILCs are small, innovative 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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