

# Continuing the Debate Over the Role of ILCs

By Stephen Falanga

Proposed Congressional legislation earlier this year, along with a bevy of state law initiatives from 2006 to the present, have continued the debate over the controversial proposal by Wal-Mart Stores Inc. to form Wal-Mart Bank, a Utah industrial bank. Most recently, the Federal Deposit and Insurance Corp. (FDIC) extended for an additional year its self-imposed moratorium for acting upon applications for industrial banks by commercial enterprises, noting that the “extension will both allow the FDIC needed time to evaluate the various issues, facts and arguments associated with the ownership of an industrial bank by a commercial company and allow Congress time to consider legislation concerning industrial banks.”

Notwithstanding their recent notoriety, industrial loan companies (ILCs) are state-chartered banks which have actually been in existence since the early part of the last century. ILCs were originally designed to serve as a small loan company for industrial workers. However, over the years, some states in which ILCs are chartered have expanded the scope of banking activities ILCs may conduct, to the point where some ILCs’ activities now match those that can be undertaken by state-chartered commercial banks. A significant feature of an ILC is that it is excluded from the definition of “bank” in the Bank Holding Company Act of 1956 (BHCA). Accordingly, in states where bank charters allow ILCs to conduct essentially the same functions as many commercial banks, an ILC can be an attractive way for a financial or commercial company to operate a bank without becoming subject to the significant reporting and regulatory requirements of the BHCA.

According to FDIC records, as of Jan. 30, there were 58 state-chartered and insured industrial banks holding an aggregate total of approximately \$177 billion in assets. Of those 58 ILCs, 45 operate in the states of Utah and California and 43 are either controlled by one or more individuals or by a parent company whose

business is financial in nature. The remaining 15 state-chartered ILCs are subsidiaries of holding companies that are non-financial in nature – commercial businesses, for example.

The firestorm over Wal-Mart’s application to form an ILC first arose in the summer of 2005, when Wal-Mart applied to the Utah Department of Financial Institutions to form a Utah industrial bank that would be wholly owned by Wal-Mart’s non-operating subsidiary, Broad Street Financial Services Inc. In filing its application, Wal-Mart stated that the proposed bank would “not be open to the general public” and would “not operate branch offices” and that the principal business of the bank was “to serve as the required depository sponsor into the electronic payment systems in connection with retail sales by Wal-Mart and its subsidiaries.” Further, the bank would “not engage in lending operations” and did not intend to compete with depository institutions for customers or services, noting that the “primary competitors for sponsorship arrangements with Wal-Mart include money center banks that perform payment processing functions.”

## Mixing Banking & Commerce

Largely in response to Wal-Mart’s banking application, a number of states began introducing legislation to amend their state banking charters in order to prohibit or significantly reduce the ability of commercial entities to apply for and form industrial banks. One of the first states to act was Maryland, which was also the subject of a newsworthy dispute with Wal-Mart over the extension of healthcare benefits to its employees.

In a bill first introduced in March 2006, the Maryland Legislature proposed amending its financial institution regulations to prohibit a banking institution or out-of-state bank from establishing or maintaining a branch in Maryland on the premises or property of an affiliate, if that affiliate engaged in “commercial activities.” The act defined “commercial activities” to mean activities in which a bank or

*Editor’s Note: As of March 16, Wal-Mart has withdrawn its application to open an industrial loan company (ILC). According to FDIC Chairman Sheila C. Bair, “This decision will remove the controversy surrounding their intentions. They don’t need an ILC to play an important role in expanding access to financial services, they can do so by partnering with banks and others. We look forward to working with Wal-Mart in meeting the need for low-cost financial services across all populations.”*

financial holding company or a national bank, or national bank financial subsidiary, could not engage in under federal law (i.e. essentially non-financial-related business activities). The bill passed and became effective in May 2006. Similar states, including Iowa, Missouri, Oklahoma and Virginia, followed suit, enacting legislation aimed at commercial ownership of industrial banks.

Since that time, other states, including Colorado, Illinois, Kansas, Maine, Michigan, Nebraska and Texas, have introduced legislation which is in various stages of consideration. Of particular note, Colorado is the only state where industrial bank legislation is either pending or enacted that currently has industrial banks operating. The Colorado statute, which is awaiting signature by the governor, provides that its intended purpose is to support, defend and promote “federal policy by precluding in every fashion the mixing of banking and commerce in Colorado.”

While numerous states were passing their own legislation to restrict the ability of industrial banks to be operated by commercial entities, similar lobbying efforts were under way in Washington, D.C., to close the loophole under the BHCA. In fact, in late January, Congress introduced largely bipartisan legislation in an effort to curb the expansion of ILCs and “close one of the remaining exceptions in the banking law that would allow retailers and other commercial firms to engage in banking.”

The introduced bill, known as the Industrial Bank Holding Company Act of 2007 (H.R. 698), if passed by Congress and signed by the president, would prohibit an industrial bank from being controlled directly or indirectly by a commercial firm. Significantly, H.R. 698 would grandfather commercial firms that have already acquired industrial banks, most

notably, one of Wal-Mart's competitors, Target. However, the proposed legislation does not appear to address the apparent uneven playing field that may result from allowing commercial entities who have already obtained industrial banks to continue their operation without federal oversight, while prohibiting other commercial firms from doing the same.

The introduction of H.R. 698 was one of the stated purposes behind the FDIC board of directors' decision to extend the moratorium for commercial enterprise industrial bank applicants until Jan. 31, 2008. The original six-month moratorium, which went into effect on July 28, 2006, was established to enable the FDIC to further evaluate "(i) industry developments; (ii) the various issues, facts and arguments raised with respect to the industrial bank industry; (iii) whether there are emerging safety and soundness issues or policy issues involving industrial banks or other risks to the insurance fund; and (iv) whether statutory, regulatory or policy changes should be made in the FDIC's oversight of industrial banks in order to protect the deposit insurance fund or important congressional objectives."

In extending the moratorium, the FDIC noted that "whatever their purpose or structure, the industrial bank charter has generated a significant amount of public interest in recent years, as various entities have explored the feasibility and business opportunities associated with an industrial bank as part of their operations." In concluding that ILCs owned or controlled directly or indirectly by organizations where "commercial activities are the predominant, if not sole, business of such companies" is cause for concern, the FDIC stated that it believes this class of companies needs further study and consideration into the areas of increased risks that may arise from commercial company ownership of ILCs and the effectiveness of current supervisory models. ▲



*Stephen Falanga is a partner in the Roseland, N.J., office of the law firm Connell Foley LLP, where he is a member of the firm's practice groups in banking law and finance, bankruptcy, reorganization and creditor's rights, as well as corporate law and transactions.*

## INDUSTRIAL BANK LEGISLATION

STATE	TITLE OF STATUTE/BILL	STATUS
Colorado	"An act concerning a limitation on the operation of industrial banks at commercial locations" (2007 CO H.B. 1175).	Introduced Jan. 18, 2007; passed both houses and awaiting signature by governor.
Illinois	"An act amending the Illinois Banking Act" (HB 4660) (HB 0497).	Introduced Jan. 12, 2006; reintroduced Jan. 30, 2007. Currently in the Senate.
Iowa	"An act relating to financial institutions, including the regulation of state banks, bank holding companies, and industrial loan companies..." ("Industrial Loan Law" Chapter 536A.1 et seq. of Iowa Code).	Enacted and signed into law. Effective July 1, 2006.
Kansas	"An act concerning banks; prohibiting the establishment of branches with commercial affiliates" (2007 S.B. 137).	Introduced Jan. 22, 2007. Passed the Senate and currently in the House.
Maine	"An act to prohibit retail store-operated banks" (LD 100).	Introduced Jan. 9, 2007.
Maryland	"An act prohibiting a banking institution or out-of-state bank from establishing or maintaining a branch in the State on the premises or property of an affiliate if the affiliate engages in commercial activities" (H.B. 1735).	Enacted and became law without governor's signature per Maryland Constitution on May 26, 2006.
Michigan	"A bill to amend the Banking Code of 1999" (2006 H.B. 5884).	Introduced March 16, 2006.
Missouri	"An act to modify laws relating to financial institutions" (Section 362.078 of the Missouri Code).	Enacted and signed into law. Effective Aug. 28, 2006.
Nebraska	"An act relating to banks and banking; to prohibit branch banking by industrial loan companies or industrial banks..." (2007 NE L.B. 113).	Introduced Jan. 8, 2007.
Oklahoma	"An act relating to banks and trust companies; creating the Oklahoma Industrial Loan Company Branch Act of 2006" (2006 S.B. 1680/ Title 6, chapter 510 of Oklahoma statutes).	Enacted and signed into law. Effective June 6, 2006.
Texas	"An act relating to location of branches of certain financial institutions" (2007 TX H.B. 341 & 944).	Introduced Nov. 30, 2006; reintroduced Jan. 30, 2007.
Virginia	"A bill to amend, repeal and reenact [certain sections] of the Code of Virginia, relating to the activities of banking institutions" (2006 H.B. 195).	Enacted and signed into law. Effective April 6, 2006.