Letter on Pending ILC Legislation

Statements & Comments

The Honorable Jesus “Chuy” Garcia
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Garcia:

On behalf of the Conference of State Bank Supervisors (CSBS),[1] I write to express our concern regarding legislation Congress is considering eliminating the exemption for industrial loan companies (“ILCs”) from the definition of a bank under the Bank Holding Company Act (“BHCA”). State regulators believe there are several misconceptions regarding ILCs and the permissible activities of ILCs and their commercial parents.

Opponents of the ILC charter allege that ILCs exist via a “loophole” in federal law, pose a safety and soundness risk due to the lack of consolidated supervision, and are more likely to engage in predatory lending that harms consumers. On this basis, legislation has been put forward to eliminate the ILC exemption. However, this legislation would do nothing to address the efforts of the Office of the Comptroller of the Currency (“OCC”) to create an unlawful, unsanctioned option for avoiding BHCA coverage by chartering uninsured national banks under this so-called “fintech charter” presenting a far graver threat to the separation of banking and commerce than the ILC.

In this letter, I address misconceptions and provide contextual information regarding the ILC exemption, the status of the ILC as a lawful option afforded by Congress, and the concerns posed by ILCs relative to those emerging from an unlawful, unsanctioned option for avoiding BHCA coverage which has emerged in recent years, the OCC’s fintech charter.

The ILC exemption is a lawful option expressly afforded by Congress, not a loophole

The ILC is not the result of a “loophole” in the BHCA as some have suggested. Rather, the ILC exemption reflects an intentional decision by Congress to expressly create an exemption in the law to allow for commercial ownership of banks in a small number of states subject to specific restrictions and limitations. This can be seen by tracing how the BHCA covered and did not cover ILCs and other institutions since its enactment.

Congress enacted the BHCA in 1956 to deter greater concentration and prevent anticompetitive practices in the banking industry.[2] Since that time, companies that control “banks” as defined by the BHCA must limit their activities to those “closely related to banking” and submit to consolidated regulation by the Federal Reserve.[3] This limitation on the activities of the parent company prevents commercial enterprises from owning “banks” as defined by the BHCA and thereby preserves the traditional separation of banking and commerce.

As originally enacted, the BHCA defined “bank” by charter type to mean “any national banking association or any State bank, savings bank, or trust company.”[4] But, in 1966 and 1970, Congress amended the definition of “bank” to narrow its coverage to only those institutions that accept demand deposits and make commercial loans.[5] Congress deliberately adopted this functional test to except from BHCA coverage certain institutions that did not take demand deposits and make commercial loans—namely, savings banks, industrial banks, and trust companies.

However, this functional definition inadvertently created a path for commercial enterprises to enter the banking system through what became known in the 1980s as the “nonbank bank loophole.”. Essentially, commercial firms would obtain a commercial bank charter but simply refrain from either demand-deposit taking or commercial lending and thereby avoid being deemed a “bank” under the BHCA and subject to regulation and supervision by the Federal Reserve—hence “nonbank bank.”.[6] The OCC solicited and received hundreds of applications for nonbank bank charters over the course 1980s.[7] This chartering campaign eventually compelled Congress to close the nonbank bank loophole through the enactment of Competitive Equality Banking Act of 1987 (CEBA).[8]

Through CEBA, Congress closed the loophole by redefining “bank” to include any FDIC-insured bank and by creating express exemptions (the “CEBA-exemptions”) for those institutions intended to be excepted under the former functional definition, including industrial banks, trust companies, credit card banks, and others (the “CEBA-exempt institutions”). All existing institutions that did not meet the CEBA definition of “bank” or an express exemption thereto were grandfathered; however, no new nonbank banks could be chartered given the FDIC insurance mandates imposed by federal and/or state law.[9]

As detailed below, Congress imposed strict conditions for institutions to satisfy the CEBA exemptions to BHCA coverage, including the ILC exemption. Unfortunately, the OCC has recently sought to create a new charter type—an uninsured national bank charter for fintech companies (commonly referred to as the “fintech charter”)—that would evade BHCA coverage and could be owned by large commercial and technology enterprises without qualifying for any of the CEBA exemptions or complying with the restrictions imposed on CEBA-exempt institutions.[10] In short, fintech charter recipients would be the nonbank banks that Congress intended to eliminate long ago.

We highlight the OCC’s recent efforts to reopen the nonbank bank loophole and contrast the fintech charter with the ILC charter here because, if Congress is to take action to eliminate the ILC exemption, Congress must also ensure that the actual loophole it intended to close through CEBA remains closed.

The OCC is actively creating a loophole in BHCA coverage by offering uninsured national banks charters through its fintech charter program

Today, the actual loophole through which commercial firms can enter the banking system is the OCC’s fintech charter, not the ILC charter. This is readily apparent by comparing the manner in which ILCs are chartered and regulated as well as the restrictions imposed on the activities and operations of ILCs relative to uninsured national banks organized under the fintech charter.

First, in closing the nonbank bank loophole through CEBA, Congress imposed restrictions on the activities of CEBA-exempt institutions, including ILCs, as a condition of obtaining exemption from BHCA coverage. For example, Congress limited the ability of ILCs and trust companies to access and/or utilize the Federal Reserve’s payment system and discount window.[11] Yet, fintech charter recipients would operate entirely free of BHCA coverage without any restriction on their ability to access these aspects of the federal safety net. Congress also imposed restrictions on the activities of CEBA-exempt institutions which significantly limit their ability to compete with banks covered by the BHCA, such as precluding ILCs from engaging in demand deposit taking,[12] limiting trust companies to acting in a bona fide fiduciary capacity,[13] and precluding credit card banks from engaging in commercial lending.[14] The activities of fintech charter recipients would not be subject to any such restrictions and yet would evade consolidated regulation and supervision under the BHCA.

Second, in expressly codifying the CEBA exemptions, Congress took care to ensure that all CEBA- exempt institutions, although not subject to BHCA regulation, remain subject to the restrictions on anti-competitive practices, such as tying, that apply to banks as defined by the BHCA.[15] And yet, because the uninsured national banks organized under the OCC's fintech charter would neither fall within any of the CEBA exemptions nor the BHCA definition of "bank," the fintech charter again simultaneously avoids all of the restrictions imposed by the BHCA coverage and all of the restrictions imposed on obtaining an exemption from BHCA coverage.

Third, and perhaps most importantly, to satisfy the ILC exemption, an ILC must be organized under a state's law that, as of CEBA's enactment, authorized ILC charters and mandated that ILCs obtain federal deposit insurance which, today, only includes six states.[16] The importance of ILC's FDIC-insured status cannot be overstated as it affects every aspect of the bank regulatory scheme from chartering to receivership. It means that organizing an ILC not only requires obtaining the approval of a chartering authority but also the approval of the deposit insurer, the FDIC. This is in stark contrast to the fintech charter for which the OCC would (unlawfully) waive the national bank deposit insurance mandate and hence the need to obtain FDIC approval.

Additionally, whereas an ILC, once organized, becomes subject to the comprehensive scheme of federal bank regulation applicable to FDIC-insured banks, institutions organized under the fintech charter simply would not. Most federal banking laws—including standardized capital requirements, prompt corrective action restrictions, the Community Reinvestment Act, and so on—are made generally applicable to FDIC-insured banks, regardless of charter type.[17] While such laws are fully applicable to ILCs, they would not apply to uninsured national banks organized under the fintech charter.

Lastly, as with all state-chartered banks, the privileges of federal preemption, including the ability to export interest rates and otherwise operate in parity with national banks, are only obtained by ILCs by virtue of their obtaining the status of an FDIC-insured bank.[18] This is important to bear in mind not only because (contrary to the suggestions of some) the applicability of state consumer protection laws to ILCs bears no special connection to its status as a CEBA-exemption institution, but also because, through the fintech charter, the OCC now seeks to insulate uninsured national banks from such laws in an unprecedented expansion of preemption.

To recap, like an ILC, an uninsured national bank organized under the fintech charter represents a path for commercial firms to obtain the special privileges traditionally reserved to FDIC-insured banks; however, the fintech charter requires less regulatory approval than the ILC charter, is not subject to the comprehensive regulatory scheme applicable to ILCs and other FDIC-insured banks, and is not subject to any of the special restrictions applicable to ILCs or other CEBA-exempt institutions. For this reason, I believe it is hardly reasonable or sensible to repeal the ILC exemption on the grounds that it represents a “loophole” in the BHCA without addressing the gap in BHCA coverage that the OCC has sought to create over the past few years through its persistent efforts to charter uninsured national banks.[19]

Conclusion

State regulators recognize concerns have been expressed about commercial ownership of ILCs and, specifically, ownership of ILCs by large tech-focused firms. State regulators share concerns regarding the role of large technology firms in the U.S. financial system. However, if a fintech or commercial firm wants to have a national presence and is willing to take on all the commitments and responsibilities that come with a bank charter, the ILC is a lawful option traditionally afforded by Congress.

State regulators believe the joint supervisory approach to overseeing ILCs with the FDIC has been effective in ensuring that ILCs with commercial parents do not present an outsized safety and soundness risk. When appropriate safeguards are in place—such as those for ILCs outlined above—state regulators and federal regulators are able to address the unique considerations that stem from commercial ownership of a depository institution as allowed by Congress.

To the extent that Congress believes the ILC exemption is no longer appropriate, we urge Congress to take action to stop the OCC’s concerted campaign to reopen the nonbank bank loophole by chartering uninsured national banks. Congress can easily do so simply by reiterating that federal law still requires what it has always required and, despite OCC’s insistence to the contrary, continues to require, namely, that national banks must be FDIC-insured in order to commence business. CSBS would be happy to consult with you as you consider legislation related to ILCs and the BHCA more generally.

Sincerely,

John W. Ryan
President & CEO

CC: The Honorable Maxine Waters, Chairwoman, House Financial Services Committee
The Honorable Patrick McHenry, Ranking Member, House Financial Services Committee

Footnotes

1 CSBS is the nationwide organization of state banking and financial regulators from all 50 states, American Samoa, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. CSBS supports the state banking agencies by serving as a forum for policy and supervisory process development, by facilitating regulatory coordination on a state-to-state and state-to-federal basis, and by facilitating state implementation of policy through training, educational programs, and exam resource development.

2 See Bank Holding Company Act of 1956, Pub. L. No. 84-511, §§ 1-12, 70 Stat. 133 (1956) (codified at 12 U.S.C. §§ 1841 et. seq.).

3 See 12 U.S.C. §§ 1843(c)(8), 1844.

4 Bank Holding Company Act, Pub. L. No. 84-511, § 2(c), 70 Stat. 133, 133 (1956) (codified as amended at 12 U.S.C. § 1841(c)).

5 See Act of July 1, 1966, Pub. L. No. 89-485, § 3(c), 80 Stat. 236, 236 (1966) (codified as amended at 12 U.S.C. § 1841 (c); Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 101(a), 84 Stat. 1760, 1760 (1970). See also S. Rep. No. 91-1084, at 24 (1970).

6 See Carl Felsenfeld, Nonbank Banks-An Issue in Need of a Policy, 41 Bus. Law. 99, 100 (1985)

7 See Davis W. Turner, Nonbank Banks: Congressional Options, 39 Vanderbilt L. Rev. 1735, 1737 nn. 7-8 (1986) ("As of June 28, 1985, the Comptroller had received 368 applications to charter interstate nonbank banks. . . . As of June 5, 1985, the Comptroller had granted preliminary approval for 279 nonbank bank charter applications").

In February 1985, a federal district court in Florida held that the OCC had exceeded its authority in accepting and approving nonbank charter applications and enjoined the OCC from further processing any applications. See Independent Bankers Association v. Conover, 1985 U.S. Dist. LEXIS 22529 (Feb. 15, 1985).

8 Pub. L. No. 100-86, § 101, 101 Stat. 552, 554 (1987). See S. Rep. No. 100-19, at 5-11 (explaining why and how Congress is "closing the nonbank bank loophole" through CEBA and stating the need for "prompt congressional action to close the nonbank bank loophole" because OCC "moved to vacate the district court injunction that prevents him from chartering new nonbank banks").

9 See, e.g., 12 U.S.C. § 222. To the extent that an institution receives demand deposits and makes commercial loans within the meaning of BHCA definition of “bank”, the BHCA itself would likewise mandate that the institution become FDIC-insured. See 12 U.S.C. § 1842(e).

10 See OCC, “Exploring Special Purpose National Bank Charters for Fintech Companies,” (December 2016) (available at https://occ.gov/publications-and-resources/publications/banker-education/files/exploring-special-purpose-nat-bank-charters-fintech-companies.html); Policy Statement on Financial Technology Companies’ Eligibility to Apply for National Bank Charters, Office of the Comptroller of the Currency, July 31, 2018 (available at https://www.occ.gov/news-issuances/news-releases/2018/pub-other-occ-policy-statementfintech.

pdf); Comptroller's Licensing Manual Supplement: Considering Charter Applications From

Financial Technology Companies, Office of the Comptroller of the Currency, July 2018

(available at https://www.occ.gov/publications-and-resources/publications/comptrollerslicensing-

manual/files/considering-charter-apps-from-fin-tech-companies.html).

More recently, the OCC accepted an application for such a charter from a state-regulated lending and payments company, Figure Technologies, and CSBS initiated a legal challenge against the OCC over this application which remains pending. See CSBS, CSBS Files New Complaint Against OCC (Dec. 22, 2020) available at https://www.csbs.org/newsroom/csbs-files-new-complaint-against-occ.

11 See 12 U.S.C. § 1841(c)(2)(D)(iv), (H).

12 See 12 U.S.C. § 1841(c)(2)(H)(i)(I).

13 See 12 U.S.C. § 1841(c)(2)(D).

14 See 12 U.S.C. § 1841(c)(2)(F)(v).

15 See 12 U.S.C. § 1843(h).

16 See 12 U.S.C. § 1841(c)(2)(H)(i). At CEBA’s enactment, the exemption covered seven states (CO, UT, NV, MN, IN ,HI, CA). But the number dropped to six when CO’s last industrial bank became inactive in 2009 and the state repealed its industrial bank statute.

17 See, e.g., 12 U.S.C. § 1831o.

18 See, e.g., 12 U.S.C. § 1831d.

The OCC exceeding its chartering authority to enable evasions of the BHCA is not a hypothetical or theoretical problem; in fact, it has already happened. See Michael Townsley, Banking on Trust Companies: A Critique of OCC Interpretive Letter 1176 (March 31, 2021). Banking & Financial Services Policy Report, Vol. 40, No. 3 (March 2021), available at SSRN: https://ssrn.com/abstract=3834609. For instance, earlier this year, through a new interpretive letter and subsequent chartering actions, the OCC departed from decades-old precedent to enable uninsured national trust companies to conduct nonfiduciary businesses, including activities within the business of banking. See OCC Interpretive Letter 1176 (January 11, 2021) (IL 1176),

available here: https://occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1176.pdf. See also OCC News Release 2021-6, OCC Conditionally Approves Conversion of Anchorage Digital Bank (Jan. 13, 2021) available at: https://occ.gov/news-issuances/news-releases/2021/ nr-occ-2021-6.html. Previously, since national trust companies were limited to acting in a fiduciary capacity and precluded from engaging in the banking business, they have not, like national banks, been required to be insured.

But, through the OCC's recent actions, it has chartered national trust companies that would engage in banking activities (in particular, custody activities) and yet would not be FDIC-insured. Since these institutions would not be FDIC-insured, they would not be a "bank" under the BHCA, but they also do not meet the CEBA-exemption for trust companies nor any other exemption and thus, like uninsured national banks formed under the fintech charter, escape BHCA coverage to a greater extent than ILCs or any other exemption. Although the banking activities engaged in by these uninsured national trust companies is custody, the new interpretive letter made clear that the OCC could charter uninsured trust companies to engage in other banking activities (such as lending and payments) all while entirely avoiding BHCA coverage.

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