

# CAMBRIDGE WINTER

Center for Financial Institutions Policy



## Industrial Loan Companies and Shadow Banking

Research Note

August 10, 2009

## 1.0 Introduction

The Cambridge Winter Center for Financial Institutions Policy<sup>1</sup> is pleased to present this research note in conjunction with its ongoing research program on the structure and stability of the U.S. financial services market.<sup>2</sup>

As part of its broad-based proposal to reform financial services regulation, the Administration has proposed the elimination of Industrial Loan Company (or “ILC”) charters.<sup>3</sup> Opponents of the proposal have noted that ILCs have typically been marked by strong capitalization and solid credit performance, and therefore cannot fairly be linked to the excesses of the credit bubble and the ensuing financial crisis.

This note summarizes the recent evolution of ILCs, examines their empirical connection to the credit crisis, and highlights implications for policy-makers.

## 2.0 Executive Summary

Although the ILC charter cannot fairly be said to have “caused” the credit crisis, it certainly was a factor within a broadly dysfunctional regulatory architecture.

Simply put, the ILC charter had, by the end of the bubble, principally become a vehicle by which an economic subsidy flowed from U.S. taxpayers, through Utah regulators and the FDIC, to the largest SEC-regulated “shadow banks” on Wall Street. By providing a taxpayer-backstopped funding source (through the FDIC), but without requiring bank holding company capital levels on ILCs’ corporate parents, the ILC charter enabled a level of risk-taking and leverage that would have been impossible had those parent firms instead been forced to own more traditional commercial banks.

That risk-taking and leverage, in turn, helped drive the size and frequency of financial distress. Remarkably, eight out of the 12 corporate parents of the largest Utah ILCs either failed or received substantial taxpayer support during 2008 and 2009. Indeed, 30% of all U.S. taxpayer support under the TARP capital purchase program, and fully 47% of the FDIC’s TLGP, has been directed to these Utah ILCs’ parents.

Given the frequency and magnitude of those parent firms’ failings, it is clear, especially in hindsight, that the FDIC’s supervi-

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<sup>1</sup> The Cambridge Winter Center for Financial Institutions Policy is a non-profit, bipartisan think tank focused on fostering a rational, fact-based dialogue on U.S. financial institutions policy. Cambridge Winter does not engage in lobbying activities, nor does it accept fees or other compensation for its services.

<sup>2</sup> Cambridge Winter is pursuing three research programs over the course of 2009-10: (1) Sleeping Watchdogs -- Bank Governance and Regulation Before the Fall; (2) Out of the Shadows -- Industry Structure as a Determinant of Financial Services Stability; and (3) Consumer Finance 3.0 -- Crisis, Reform, and the Next Decade of Consumer Lending. This research note is published under the program entitled “Out of the Shadows”.

<sup>3</sup> U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation (“Treasury White Paper”), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf), accessed August 6, 2009, pages 34-35.

sion of insured ILC subsidiaries, coupled with the SEC's now defunct "consolidated supervised entities" program oversight of parent companies, is an inadequate substitute for robust consolidated supervision of holding companies. Although the FDIC (and Utah state regulators) have, so far, prevented catastrophic failure within ILCs themselves, their supervision did nothing to stem systemic risk, and very likely encouraged it: The FDIC's deliberately myopic institutional focus on ILCs' safety and soundness, coupled with the SEC's permissive approach to ILC parents' capital levels, helped subsidize and enable many of the high-leverage shadow banks that ultimately hastened and deepened the crisis.

### 3.0 Evolution of the ILC Market

ILCs, in one form or another, have existed for nearly a century. They are essentially limited purpose banks, particularly as they are seen through the lens of ordinary customers: they accept deposits; they make consumer and commercial loans.

Despite that seeming functional equivalence to traditional banks, however, ILCs are not defined as "banks" for purposes of the Bank Holding Company Act.<sup>4</sup> In practi-

cal terms, that creates two advantages for the corporate parents of ILCs over the corporate parents of banks: (1) freedom from bank holding company ("BHC") capital requirements; and (2) freedom from the restriction of BHCs to financial activities.<sup>5</sup>

Mindful of the disparate regulatory treatment between ILCs and banks, Congress tightened the ILC loophole in the Competitive Equality Banking Act of 1987 ("CEBA").<sup>6</sup> Since then, new ILCs have been confined to a small number of states that happened to have been "grandfathered" in 1987 -- Utah, California, and Nevada chief among them. Moreover, unless post-1987 ILCs are small (less than \$100 million in assets), they are not permitted to accept demand deposits (so they tend not to offer traditional checking accounts, or commercial transaction accounts).<sup>7</sup>

The ILC market changed in four substantial ways after CEBA's 1987 reforms. To examine those four trends, it is useful to compare the state of the ILC market in 1987; in 2004 (towards the leading edge of U.S. credit excesses); and in 2009 (after most of the structural impact of the credit crisis and federal bailout efforts).

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<sup>4</sup> 12 U.S.C. 1841(c)(2)(H).

<sup>5</sup> See U.S. Government Accountability Office, Report GAO-05-621 (September 15, 2005) ("GAO ILC Report"), pages 10-18.

<sup>6</sup> Pub. L. No. 100-86.

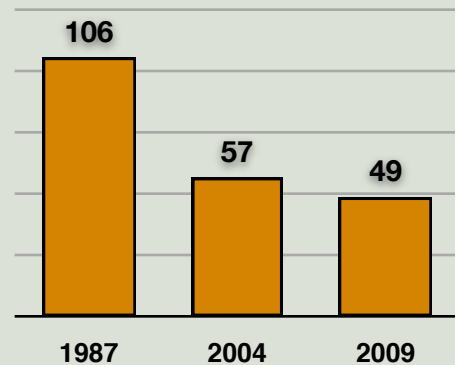
<sup>7</sup> GAO ILC Report at 17. Beyond Utah, California, and Nevada, three other states were grandfathered: Minnesota, Colorado, and Hawaii. *Id.* at n. 17. Those six states, plus Indiana, are the only states with extant ILCs today.

### 3.1 Declining numbers

First, the number of ILCs has dwindled since 1987. (See Figure 1). This is presumably due to CEBA's tightening of the ILC loophole, but also to two more recent dynamics.

First, in July 2006, the FDIC imposed a moratorium on new applications for ILC deposit insurance. Wal-Mart Stores, Inc., the largest U.S. retailer, had applied for an ILC charter and associated FDIC insurance in July 2005, and touched off a heated political debate on whether the ILC charter was permitting too much mixing between commercial and banking enterprises. In order to give itself, and Congress, time to weigh

Figure 1  
Number of ILCs



Source: GAO; FDIC

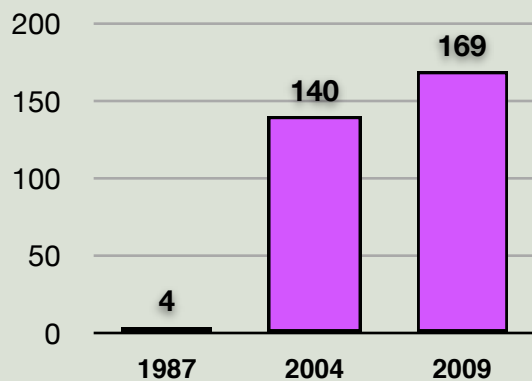
the matter, the FDIC put ILC applications on hold.<sup>8</sup>

By the time the moratorium lifted in January 2008, of course, the credit crisis was mounting in urgency. And, as part of the Bush Administration's 2008 response to the crisis, a number of distressed firms' ILC subsidiaries were, in expedited fashion, converted into traditional commercial banks, such that their distressed parents could be converted into BHCs and thereby qualify for immediate taxpayer capital support through the TARP. Converted ILCs included those owned by Goldman Sachs, Morgan Stanley, GMAC, American Express, and CIT. As a result, the number of ILCs has declined further over the past year.

### 3.2 Massive asset growth

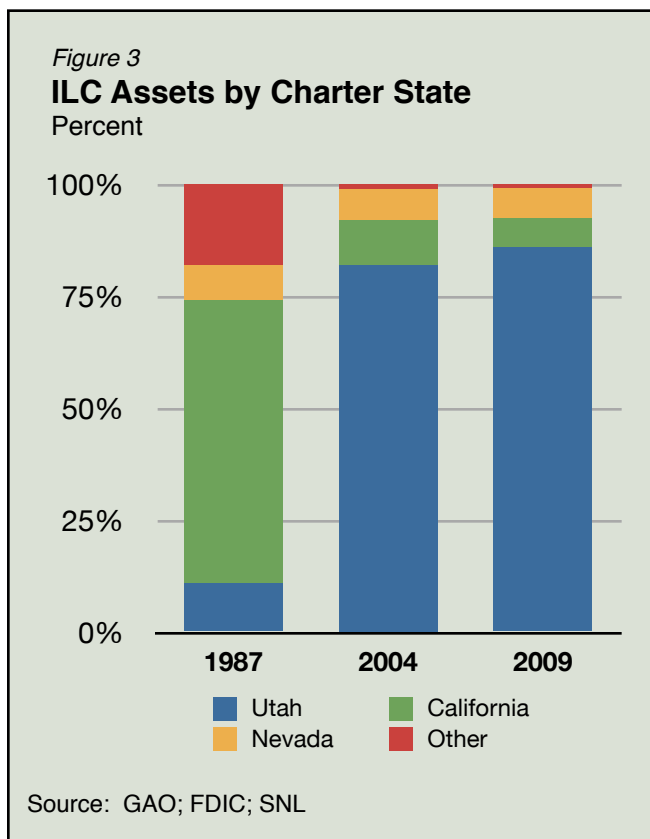
The broadly declining number of individual ILCs after 1987, however, was in marked

Figure 2  
Assets of ILCs  
\$ Billions



Source: GAO; FDIC

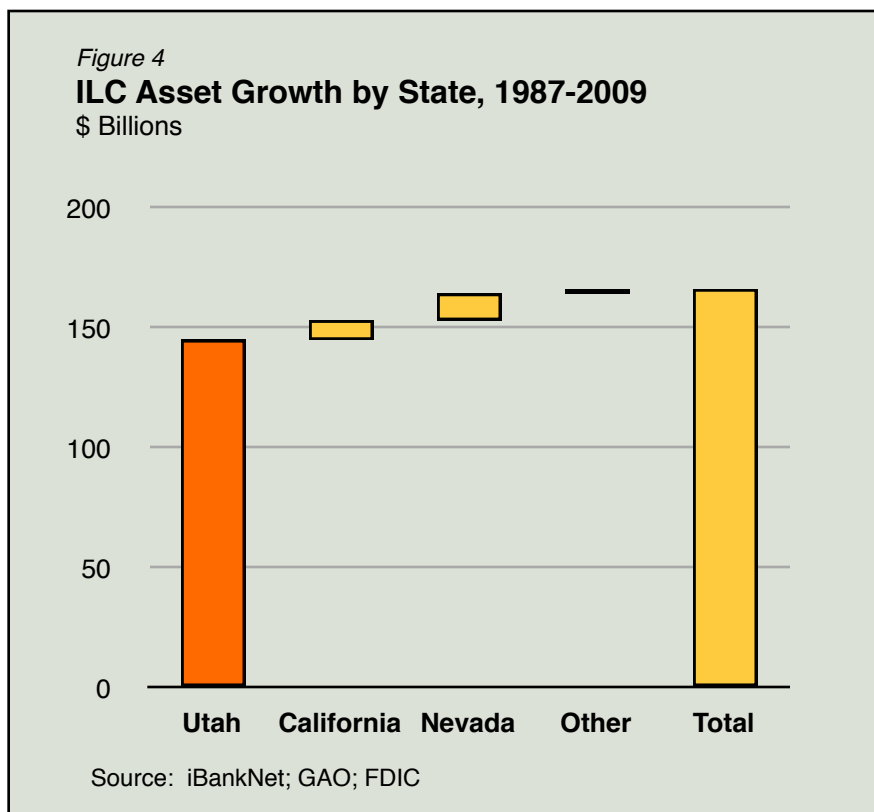
<sup>8</sup> See Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217 (Feb. 5, 2007) (extending moratorium an additional 12 months).



contrast to the growth in the assets held by ILCs. Between 1987 and 2009, ILC deposits grew at a 21% compound annual growth rate. That is several times faster than broader bank deposits grew over the same period. By the end of the credit bubble, nearly \$170 billion in assets were held by ILCs. (See Figure 2).

### 3.3 Dominance of Utah

Perhaps more striking than the absolute growth of ILC assets is the dominance of a single state in that growth trajectory: Utah. From only 11% of a dramatically smaller industry in 1987, Utah today commands some 86% of the industry's ILC assets -- and that is *after* the conversion of several large Utah ILCs into commercial banks. (See Figure 3).



Put another way, the vast majority of the growth in the U.S. ILC market has, in reality, been attributable to growth in Utah ILCs. (See Figure 4). Indeed, as a result of outsized ILC growth, by the middle of 2008 more than 90% of Utah's state-chartered depositories' assets were in ILCs.

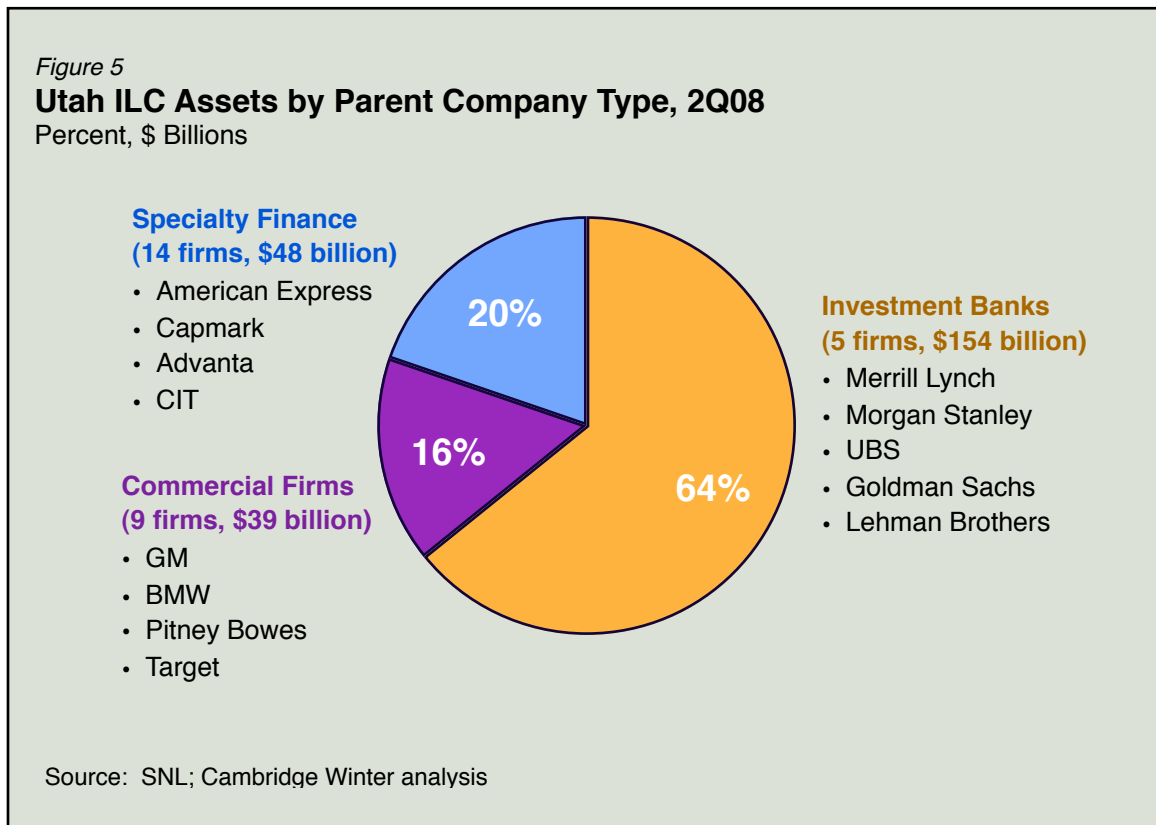
### 3.4 Wall Street takeover

The dramatic growth of Utah's ILC system was the result of a major shift in the types of institutions seeking the benefits of the ILC regulatory loophole. In particular, the ILC became, over the past decade, disproportionately used large Wall Street investment banks.

Notably, the role of Wall Street has tended not to figure prominently in the public debate of the ILC loophole's merits. Instead, public debate has typically revolved around two kinds of putative corporate parents: non-financial corporates (e.g. Toyota, Pitney Bowes) seeking captive finance arms; and niche specialty finance firms (e.g. Advanta, CIT). This is understandable, given ILCs' historical context, which both began with and has been punctuated by the concept of non-financial ownership, and has

also been marked by a significant focus on non-prime niches.<sup>9</sup>

Modern use of the ILC charter, however, has surprisingly little to do with use or abuse by commercial enterprises, or by niche specialty finance firms. Rather, as demonstrated above, modern use of the ILC charter has been shaped almost entirely by its growth in Utah. And growth in Utah has been mostly shaped by the largest Wall Street investment banks. Indeed, just before the series of taxpayer-funded



<sup>9</sup> ILCs' genesis was in the "Morris Plan" firms of a century ago, which were mostly non-prime consumer finance arms of industrial concerns. Later, in the mid-1980's, non-financial corporates increasingly sought ILC affiliates, so as to provide captive financial services without the attendant complexity of BHC regulation. It was this perceived interest by non-financials that helped hasten the CEBA reforms in 1987. See generally, FDIC, The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective, FDIC Supervisory Insights (June 25, 2004). And, as noted above, controversy surrounding Walmart's 2005 application renewed attention to the mixing of commercial and banking interests through the ILC vehicle.

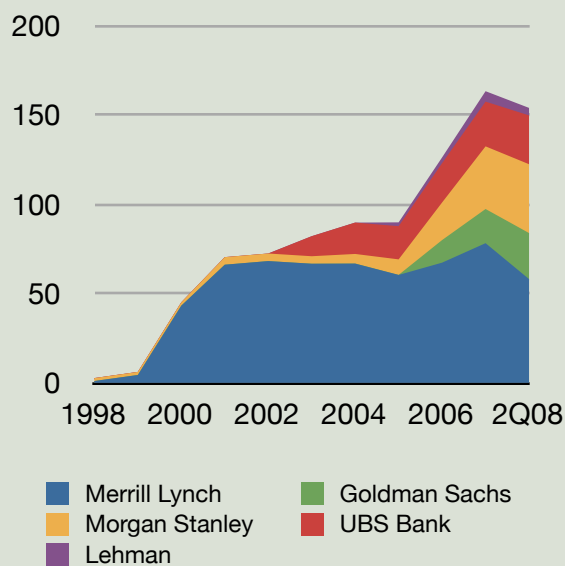
bailouts began in late 2008, fully 64% of the assets in Utah's ILC system were controlled by five major Wall Street houses. Commercial, non-financial firms, by contrast, accounted for just 16% of assets. (See Figure 5).

The growth of investment banks' ILC subsidiaries was so extensive, in fact, that their growth -- from a standing start -- over the 10 years from 1998 to the middle of 2008 generated roughly \$150 billion in assets. That accounts for nearly 90% of the net growth in the *entire* U.S. ILC market since 1987.

The pattern of the Wall Street firms' growth is instructive. Merrill Lynch, presumably by converting many of its brokerage clients' uninvested balances into bank deposits, led the way from 1999-2001, quickly building the largest ILC in history. The other Wall Street firms -- Goldman, Morgan Stanley, and UBS in particular -- followed Merrill's example two years later. In an industry where taxpayer-backstopped leverage can be a killer advantage, it appears that the prospect of FDIC-insured deposit funding, without the entanglements of bank holding company supervision, proved too attractive to ignore. (See Figure 6).

Figure 6

### Investment Banks' Utah ILC Assets \$ Billions



Source: SNL; Cambridge Winter analysis

## 4.0 ILCs and the Crisis

ILCs themselves -- that is, the actual legal entities chartered as ILCs, not their ultimate parents -- have, for the most part, avoided direct catastrophic failure during the course of the credit crisis. Indeed, ILCs' portfolios have sometimes proven to be some of the most sound assets within otherwise deeply troubled consolidated balance sheets (*e.g.* GMAC, CIT).<sup>10</sup>

But the indirect connection between ILCs and the crisis is more complicated, and is best addressed in two stages: (1) Irrespective of their own relative health, were

<sup>10</sup> Technically, even Fremont Investment and Loan, the California ILC whose parent company was a major player in subprime mortgages, did not fail. Its parent company filed for Chapter 11 on June 18, 2008, and a month later sold the assets and liabilities of the depository to a new California ILC, which was formed for that purpose by CapitalSource Inc., the Maryland-based commercial finance company. The acquiring entity, Capital Source Bank, converted from an ILC to a commercial bank charter later in 2008.

Figure 7

**Largest Utah ILCs Corporate Parents, 2Q08**

\$ Billions

BAIL-OUT?	ILC PARENT	TYPE	ILC ASSETS	TARP	TLGP
✓	1. Merrill Lynch	Investment bank	58.0	30.0	28.5
✓	2. Morgan Stanley	Investment bank	38.5	10.0	23.8
✓	3. GMAC	Commercial	31.9	12.5	4.5
	4. UBS	Investment bank	27.3	--	--
✓	5. Goldman Sachs	Investment bank	25.8	10.0	21.6
✓	6. American Express	Finance company	25.3	3.4	5.9
	7. Capmark	Finance company	8.3	--	--
✓	8. General Electric	Commercial	5.3	--	47.3
✗	9. Lehman Brothers	Investment bank	4.2	--	--
	10. BMW	Commercial	2.9	--	--
	11. Advanta	Finance company	2.8	--	--
✓	12. CIT	Finance company	2.6	2.3	--
				<b>\$68.2</b>	<b>\$131.6</b>

Notes: TARP figures refer only to capital investments. Merrill Lynch figures are for Bank of America, but exclude 2008 TARP investments into Bank of America prior to Merrill acquisition, and TLGP issuance out of Bank of America N.A. Other government assistance (e.g. commercial paper programs, TALF, increased insured deposit limits) excluded.

Source: SNL; Cambridge Winter analysis

ILCs disproportionately affiliated with parent firms that failed or were forced to seek taxpayer assistance? And, if so, (2) did existence of the ILCs themselves cause or contribute to the corporate parents' distress?

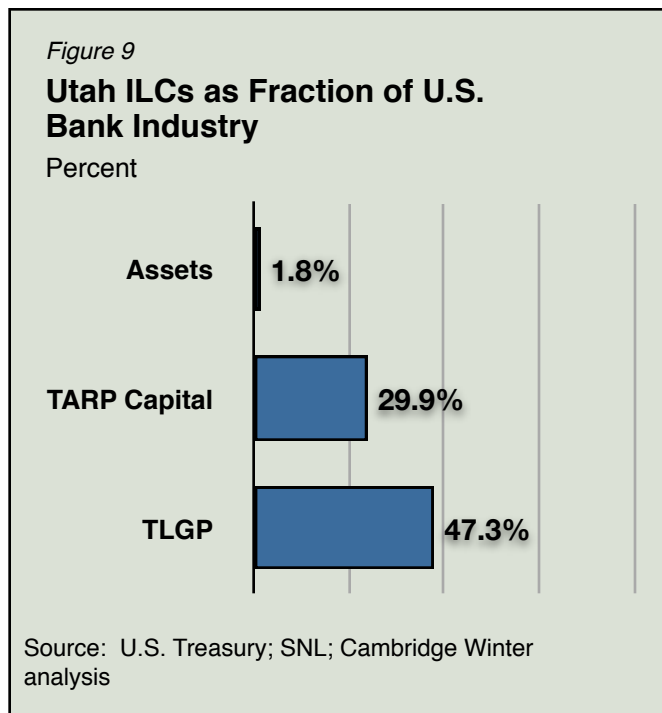
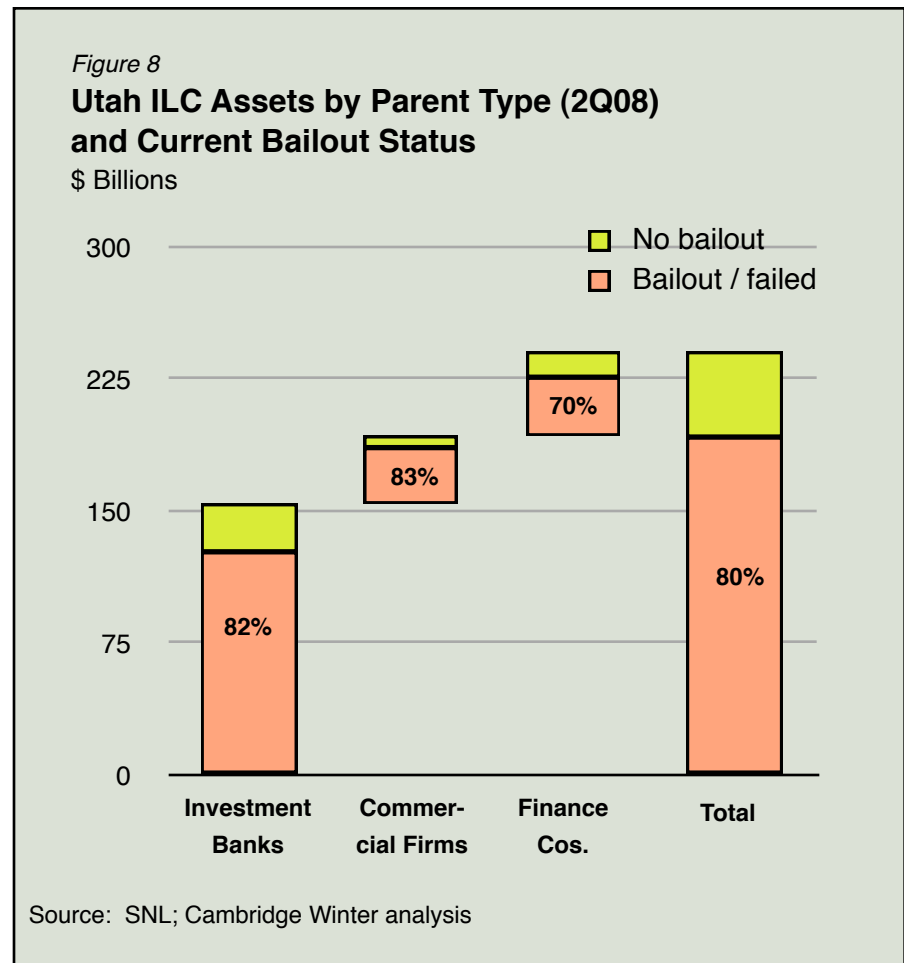
#### 4.1 Failed parent companies

The first stage of that two-part inquiry yields startling results. The largest ILCs, particularly in Utah, have been remarkably correlated with large parent company bailouts. Fully two-thirds -- 8 of the top 12 -- of the parent companies of the largest Utah ILCs either filed for bankruptcy, or required taxpayer assistance through capital or li-

quidity support. (See Figure 7).

Together, those bailout-affiliated ILCs accounted for fully 80% of the assets in the Utah ILC market, and 77% of the assets in the entire Utah state-chartered banking system. Notably, it was not just investment banks that drove these totals. A single outsized captive finance company (GMAC) and a single outsized finance company affiliate (American Express) render the non-Wall Street data troubling as well. (See Figure 8).

Perhaps more remarkably,

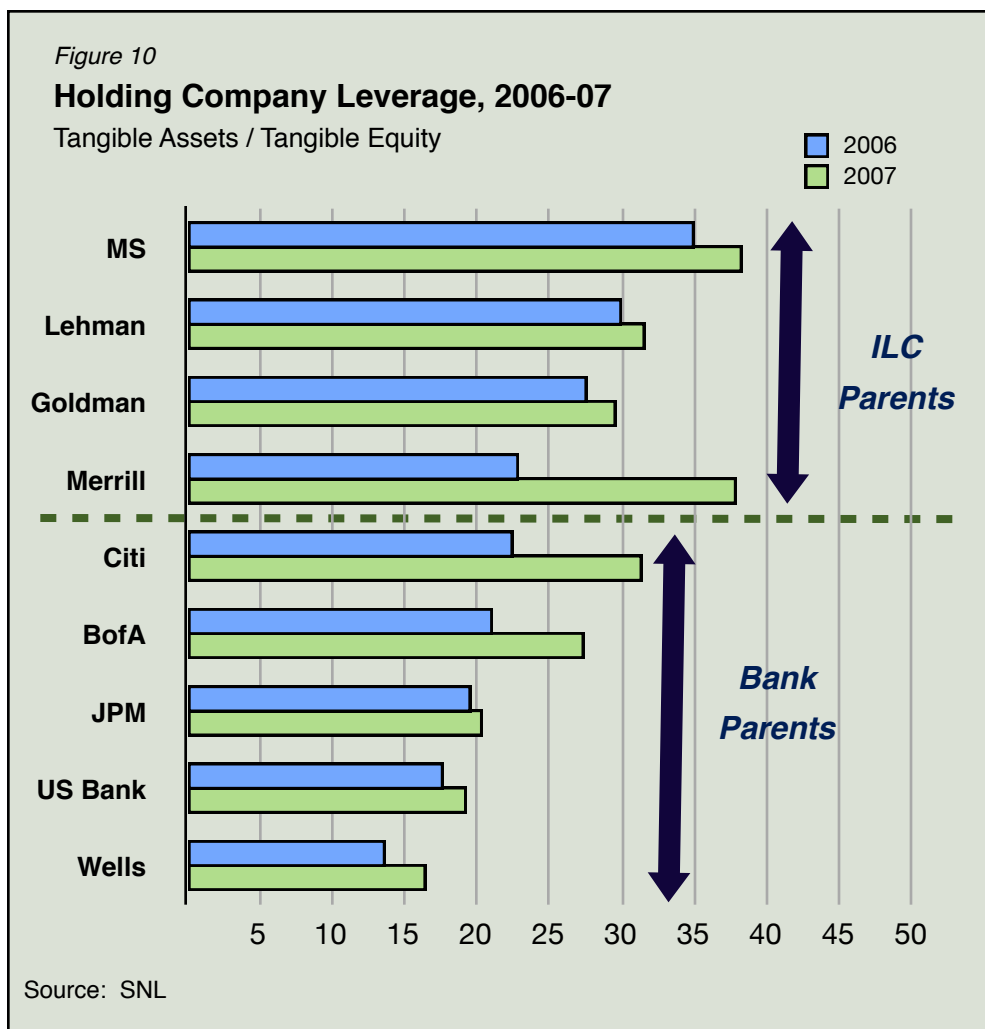


although Utah-chartered entities account for a tiny fraction of banking assets nationwide, the parents of Utah ILCs consumed nearly 30% of all taxpayer-funded capital investments under TARP, and fully 47% of all debt guarantees under the TLGP. (See Figure 9).

#### 4.2 ILCs as enablers

The connection of ILCs to the credit crisis, then, is nuanced. On the one hand, ILCs appear to have been highly correlated with parent company failures and taxpayer bailouts. On the other hand, ILCs themselves have proven reasonably resilient to credit and liquidity-related distress.

The explanation to this seeming contradiction is found in the core regulatory arbitrage created by the ILC charter. Investment banks that owned ILCs managed to avoid treatment as bank holding companies. That meant they could avoid the Fed's (relatively) high capital requirements, in favor of the SEC's relatively low requirements. That explains how firms like Morgan Stanley or Goldman Sachs, at the height of the bubble, had considerably higher leverage than, say, J.P. Morgan or Wells Fargo -- or more even than the famously troubled Bank of America and Citigroup (See Figure 10).



Higher leverage, of course, helps drive financial outperformance when markets are awash in liquidity. But by permitting high holding company leverage, the ILC-enabled regulatory arbitrage helped set firms up for failure (or bailout) upon a downdraft in credit conditions. Given the broad-based liquidity squeeze beginning in early 2008, and reaching its zenith in late 2008, firms that had been running extraordinarily high leverage faced financial distress. Given that the ILC charter attracted and enabled precisely those kinds of highly levered firms, the distress among ILCs' corporate parents should not be surprising.

## 5.0 Implications

Policy-makers should draw a few concrete lessons from the experience of ILCs in the crisis.

First, the opportunity for regulatory arbitrage, especially when it affects a core strategic element like capital levels, rarely goes unexploited. During the credit bubble, the ILC regulatory loophole was disproportionately exploited by the largest, most sophisticated, most highly levered shadow banks.

Second, the FDIC's conceptual arguments against BHC-like consolidated supervision

of ILC holding companies -- with the benefit of hindsight -- appear to have been almost precisely incorrect. When a detailed GAO Report in 2005 pointed out the uneven playing field created by the ILC charter, the FDIC argued (successfully) for no Congressional reform. The FDIC was concerned that (1) BHC-like regulation would be too costly and burdensome for Wall Street firms; and (2) tighter regulation would create the implicit expectation of a federal safety net for investment banks.<sup>11</sup> Both arguments, made during the heady days of the credit bubble, have been discredited by the experience of the crisis. Given the profound costs to taxpayers inflicted by Wall Street distress, the feared costs of regulation to Wall Street seem trivial in retrospect. And, despite the FDIC's anxiety in 2005 about an *implicit* extension of the safety net, in 2008 the FDIC and other federal agencies *explicitly* extended the safety net to investment banks during the crisis (e.g., BHC conversions, TLGP).

Finally, the experience of Utah ILCs painfully illustrate the shortcomings of the bank-centric supervisory model. The single-minded focus on a bank subsidiary's safety and soundness, unfortunately, does not, even when successful, necessarily contain risk to the financial system, taxpayers, or the economy. Through the FDIC's deliberately myopic lens, its supervision of ILCs has succeeded; ILCs have not failed. But that myopia has real systemic costs: the ILC charter helped enable many of the largest and most damaging shadow banks in the system.

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<sup>11</sup> GAO ILC Report, *supra* note 5, at 92-97 (FDIC Chairman's comments criticizing GAO report).