



The FDIC on the Spot

By Peter J. Wallison

January 31, 2008, is an important date at the Federal Deposit Insurance Corporation (FDIC). On that day, its moratorium on permitting nonfinancial organizations to charter or acquire industrial loan companies (ILCs) will expire. ILCs are bank-like depository institutions that can accept insured deposits and make loans but that, unlike ordinary banks, can also be controlled by companies not exclusively engaged in financial activities. The moratorium was put in place in order to give Congress time to adopt legislation that would prohibit retailers and other nonfinancial companies from acquiring or chartering ILCs, but Congress adjourned without adopting such legislation. Lately, the FDIC has been sending signals that it will not extend the moratorium, but it has been coy about whether it will then “slow-walk” applications so that Congress will still have time to act. This is understandable, because the agency is under strong congressional and banking industry pressure to keep the window open for legislation. But allowing the moratorium to continue, in reality or in effect, will be a defeat for the rule of law with no sound basis in policy. And if it leads to the adoption of restrictive legislation by Congress, it will embroil the FDIC in political controversy well into the future. Given these factors, the right decision for the agency is clear.

When Congress adjourned in mid-December, it left town without enacting legislation that would change the special status of ILCs under the banking laws. The exception for ILCs, first adopted in 1987,¹ was continued by Congress under the Gramm-Leach-Bliley Act (GLBA) of 1999,² which expanded the range of companies that could control insured banks but limited it to companies engaged in financial activities, such as insurance underwriting or securities dealing. The carve-out for ILCs made them uniquely attractive because it permitted nonfinancial companies, including retailers and automobile companies, to charter and operate subsidiaries that compete with ordinary banks by engaging in consumer or small-business lending and insured deposit-taking.

When Wal-Mart attempted to charter an ILC in 2005, the ILC exception became a signal issue for the banking industry, which feared the development of a major interstate competitor. Legislation

to restrict the ownership of ILCs was introduced in Congress in 2005 and each year thereafter, but with Wal-Mart’s move, this legislation acquired greater urgency; efforts to close the “ILC loophole” continued even after Wal-Mart withdrew its application in March 2007, including a bill enacted by the House and hearings in the Senate Banking Committee.

The failure of Congress to act on new legislation restricting ownership of ILCs puts the FDIC on the spot. As the agency responsible for granting federal deposit insurance for state-chartered depository institutions such as ILCs, the FDIC became the center of a firestorm of protests from the banking industry when Wal-Mart sought an ILC charter. Regrettably, the FDIC buckled. In July 2006—ostensibly to explore the policy issues associated with ILC ownership by retailers and other commercial firms—the FDIC adopted a moratorium on approving new ILC charters for nonfinancial companies. Until that time, it had freely granted such applications—even to competitors of Wal-Mart. When Congress had not acted by the beginning of 2007, the agency’s moratorium was extended until

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January 31, 2008. Thus, the moratorium is scheduled to end well before the returning Congress will have time to act on any legislation. Although FDIC chairman Sheila Bair has said that the moratorium will not be extended, she and other members of the FDIC's board of directors are now and will in the future be under heavy pressure from Congress and the banking industry either to retain the moratorium's restrictions or to slow down the processing of applications from nonfinancial firms until Congress acts. The agency has been sending signals that it will end the moratorium, but it has not yet committed itself to the prompt processing of the applications now before it.

It will be unfortunate if the FDIC again accommodates these demands. The moratorium itself appears to have no valid legal basis and was improvidently adopted; since the enactment of GLBA, there has been no sound policy foundation for restricting the activities of companies that own ILCs, and if the restrictive legislation now before Congress is ultimately adopted, the FDIC will be saddled with the impossible and politically freighted task of determining whether a particular activity of an ILC's parent company is "financial in nature." The FDIC, at the expense of its reputation for fair enforcement of the law, has given Congress more than enough time to act. Now, the best course—for the rule of law, as well as sound policy—would be to let the moratorium expire and begin immediately to process its backlog of applications by nonfinancial companies.

The Law and the FDIC's Moratorium

There is nothing in the Federal Deposit Insurance Act or GLBA that authorizes a "moratorium" or a halt in the processing of applications for deposit insurance filed by ILCs. In fact, the imposition of a moratorium appears to be legally invalid. The question of whether an executive agency may impose a moratorium on a policy or program authorized by Congress raises profound questions of the separation of powers. The Anti-Impoundment Act,³ adopted by Congress during the Nixon administration, was intended to prevent the president from refusing to spend funds that Congress had appropriated. The constitutional mandate that the president "take care that the laws be faithfully executed" is emblematic of a constitutional order that should be respected by all agencies of the government: Congress makes the laws, and the executive branch is required to execute them as written. The fact that powerful members

of Congress demand that an agency stop obeying the law is not a valid condition for imposing a moratorium or—what is the same thing—slowing down the processing of applications so that Congress will still have time to act.

There are only a few court decisions assessing the validity of executive branch moratoriums on the enforcement of congressionally mandated programs, but generally courts have held that an executive branch agency may refuse to execute a law only when Congress intended to grant the agency the discretion to do so.⁴ In the case of the Federal Deposit Insurance Act, the FDIC is not given discretion to deny applications for insurance because of the nature of the activities of the parent company of an ILC,⁵ and significantly, in its announcement of the moratorium, the FDIC did not cite any legal authority for its action.⁶ Now, with Congress having failed to act and the agency seeming to lack any authority to impose the moratorium, the FDIC would appear to be bound by law to terminate the moratorium and begin processing applications at the end of January.

Slowing that process to a crawl would amount to the same thing as a moratorium, and, to the extent that Congress encourages this behavior, it weakens its own claim to be the body that makes the laws. Our government functions well because the executive and judicial branches take seriously the respective roles of each body. But if the executive can simply stop enforcing a validly adopted law because some in Congress object, the door is open to partisan and other manipulation of the constitutionally mandated process.

The Policy Issues

If the FDIC's action had any basis in policy, it was to protect the deposit insurance fund against the supposed risks associated with affiliations between banks and commercial companies. Thus, in connection with its first moratorium, the agency noted: "Recently, the growth of the ILC industry, the trend toward commercial company ownership of ILCs and the nature of some of the business models have raised questions about the risks posed by ILCs to the Deposit Insurance Fund, including whether their commercial relationships pose any safety and soundness risks."⁷ This concern—that there is some risk to banks controlled by nonfinancial companies—is also what underlies the provisions of GLBA that authorize the Federal Reserve Board to prevent companies that are not engaged

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in financial activities from acquiring control of or continuing to control FDIC-insured banks. By permitting banks to be controlled only by companies engaged in financial activities, it is argued, Congress intended to protect banks, and the financial safety net maintained by the Fed and the FDIC, against risks of association with commercial—that is, nonfinancial—activities.

To be sure, if it were true that affiliations between insured banks and nonfinancial activities posed greater risks to banks than affiliations with financial activities, the FDIC's position might carry some weight. The agency, after all, is responsible for protecting banks against losses that will deplete the deposit insurance fund. As discussed below, however, in enacting GLBA, Congress had to conclude that existing laws and regulations were sufficient to insulate insured banks from the risks associated with control by nonbanking organizations of any kind. Under these circumstances, the carve-out for ILCs is consistent with the policies of GLBA; thus, in approving deposit insurance for ILCs owned by nonfinancial companies, the FDIC would be acting in a manner fully consistent with both the language and the underlying policies of GLBA.

This is clear for the following reason: if there is any risk to a bank's solvency, it is greater when a bank is affiliated with a securities firm—a permitted affiliation under GLBA—than when it is affiliated with nonfinancial firms such as retailers or manufacturers. In other words, by permitting banks to affiliate with securities firms, Congress must have accepted the idea that existing laws and regulations adequately protect banks against the risks of association with any other activity, financial or commercial. Accordingly, Congress's decision to leave intact the carve-out for ILCs in GLBA was ultimately based on a conclusion that banking laws and regulations are sufficient to protect insured ILCs against overreaching or exploitation by nonfinancial parent companies.

To clarify this point, it is useful to review the three policy reasons underlying the idea that banking should be separated from commercial activities but not from financial activities such as securities or insurance.

Preferential Lending and Denial of Credit. The argument here is that if a commercial firm were to control a bank, it might force the bank to lend preferentially to the commercial parent or the parent's affiliates or forbid the bank from lending to the parent's competitors. These actions, should they occur, are said to interfere with the efficient and fair allocation of credit.

If preferential lending were to occur, however, it would violate federal banking law and regulations, resulting in what could be potentially devastating personal consequences for the bank officials who permitted or participated in it. For example, sections 23A and 23B of the Federal Reserve Act place a limit (20 percent of a bank's capital or about 2 percent of risk-based assets) on the aggregate principal amount of the loans a bank may advance to all its affiliates as a group and also require that this lending take place at arm's length and be secured by collateral of up to 130 percent of the principal amount of the loan. To enforce this and other restrictions, section 1818 of the Federal Deposit Insurance Act imposes criminal liability and a possible *personal* fine of up to \$1 million per day on any bank official who approves a violation of banking law or regulations, including these provisions of sections 23A and 23B. Accordingly, it would be irrational for a bank or ILC official to risk a penalty of that kind in order to make a preferential loan to an affiliate.

Because Congress allowed banks to affiliate with securities firms under GLBA, it must have concluded that these and other banking laws and regulations have eliminated the problem of preferential lending. Securities firms, which carry their inventories of securities with bank financing, are among the heaviest users of bank credit. If the possibility of preferential lending was not considered significant enough to require special restrictions on bank lending to affiliated securities firms, there is no reason to suppose that preferential lending between banks and commercial firms would be more of a problem.

GLBA is also relevant for considering whether banks or ILCs that are affiliated with commercial firms might deny credit to competitors of their affiliates. The law makes no special provision for the possibility that banks affiliated with securities firms or insurance companies might refuse to extend credit to the competitors of these affiliates. This is particularly significant because GLBA was heavily negotiated and adopted only after the concerns of many interested parties were addressed. There are thousands of securities firms and insurance companies that—directly or through their trade associations—participated in the development of GLBA, yet the act contains no provision that would address and attempt to prevent the possibility that many of them would have to compete with companies affiliated with banks.

The reason for this is obvious. There are now so many sources of credit in the United States that even if a bank were to refuse to lend to the competitors of its affiliated insurance company or securities firm, those competitors

would have no trouble getting bank or other financing elsewhere. Again, if Congress did not think denial of credit was a significant danger when it permitted affiliations between banks and securities firms or insurance companies, there is no reason to believe that it would be any more significant if banks or ILCs were affiliated with commercial firms.

Lending to Financially Troubled Affiliates and Extending the Safety Net. In this case, the argument is that if a commercial parent were to control a bank, it might misuse the bank as a financing source when the commercial firm needs credit but cannot find it elsewhere because of its own weak financial condition. This would, in effect, extend the bank safety net to its commercial parent.

The laws and regulations applicable to banking are also relevant on this issue. Loans to affiliates must be at arm's length, and bank officers who provide credit to a financially weak affiliate are placing themselves and their families at risk for enormous personal fines and criminal charges. Obviously, securities firms encounter financial difficulties; indeed, as discussed below, securities firms are among the riskiest businesses in our economy. But in adopting GLBA, Congress did not see any need—beyond the applicability of sections 23A or 23B—to restrict lending by banks to their securities affiliates.

Commercial Activities Are Riskier than Financial Activities. This idea has two implications: that commercial parent companies create greater risks than financial companies and that, for the same reason, a commercial parent cannot be a reliable source of strength for a bank subsidiary. It is not true, however, that commercial activities are riskier than financial activities. As noted above, securities firms, which can now control banks, are among the riskiest enterprises in our economy. Their productive assets—sales personnel who have client relationships—go down the elevator every night, and these employees and their customers are highly sensitive to the firm's reputation in the market. That is why otherwise sound securities firms such as Kidder Peabody and Drexel Burnham imploded quickly after encountering financial scandals. The loss of confidence in both firms caused a withdrawal of customers and the migration of sales personnel and other productive employees to competing firms.

Commercial firms, in contrast, generally own their productive assets or control them under enforceable contracts. They are subject to the risk of loss, of course, but in the absence of fraud, they are not subject to the kinds of quick

implosions that occur in the financial industry when there is a loss of market confidence. Accordingly, once Congress allowed securities firms to acquire banks, it in effect conceded that the “source of strength” argument for the continued separation of banking and commerce had no merit.

Accordingly, the policy arguments that might favor the continuation of the FDIC's moratorium beyond January 31 all cut the other way. Allowing banks to affiliate only with financial firms would not protect them against losses. In reality, if there were to be any overreaching by its affiliates or its parent, that risk is eliminated by the FDIC's own authority—together with the Federal Reserve's authority to enforce sections 23A and 23B—to punish any violations of banking law and regulation with severe personal penalties on bank officials who take actions that are harmful to the bank. The activities of the parent or affiliate are not relevant, and if they were, there is far greater danger in permitting banks to affiliate with securities firms than with retailers or manufacturers. This may explain why Congress did not limit the affiliations of ILCs; it may have concluded that if ILCs were acquired by or affiliated with commercial firms, there would be no danger to the ILCs themselves or to the deposit insurance fund.

Finally, even the congressional sponsors of legislation that would forbid commercial ownership of banks do not believe that banking and commerce should be fully separated. Shortly after the House of Representatives adopted legislation that would restrict nonfinancial ownership of ILCs, the chairman of the House Financial Services Committee, Barney Frank (D-Mass.), said that he would be willing to permit automobile companies to control ILCs,⁸ and the draft of a Senate bill circulated by Senate Banking Committee chairman Christopher Dodd (D-Conn.) would also permit auto companies to control ILCs.⁹ Obviously, auto companies are commercial (that is, nonfinancial) firms, and their control of ILCs would breach the “wall” between finance and commerce that the FDIC's moratorium was intended to protect. It should thus be clear that by continuing the moratorium—or holding up approvals by the slow processing of applications—the FDIC will not be protecting a principle such as the separation of banking and commerce but only the proclivities of Congress to protect favored industries.

The Effect on the FDIC

Apart from the lack of legal or policy support for instituting or continuing the moratorium, the legislation currently before Congress would be harmful to the FDIC

itself. The bill passed by the House of Representatives on May 21, 2007 (H.R. 698, the Industrial Bank Holding Company Act of 2007), is a clone of GLBA and the Bank Holding Company Act. It would require the FDIC to determine whether a company that proposes to acquire or charter an ILC is a “commercial firm”—defined as a company that receives at least 15 percent of its annual gross revenues from “activities that are not financial in nature.” This test creates two difficult inquiries—whether an activity is not financial in nature and whether the carrying on of the activity is responsible for more than 15 percent of a company’s revenues.

It is impossible to draw a principled line between financial and commercial activities and thus impossible to determine what percentage of a company’s revenues are from nonfinancial activities. An example is the Fed’s inability to decide, after eight years, whether real estate brokerage is a financial activity. Clearly, securities brokerage is a financial activity; why would real estate brokerage be different? One reason might be that real estate brokerage involves real assets, but securities involve financial assets—or, more generally, securities brokerage involves intangibles—while real estate brokerage involves tangibles like houses and land. These might be useful conceptual distinctions—that is, until one considers leasing. Leasing is clearly a financial activity, long permitted to banks, so brokering leases, like brokering securities, would seem to be a financial activity. And leases are also, like securities, intangible interests in real things. If so, we have come full circle to real estate brokerage, since real estate brokers also broker leases in real estate. This brief set of examples shows how thorny is the question of whether something is or is not a financial activity.

To be sure, part of the Fed’s problem in coming to a decision on real estate brokerage is the opposition in Congress, stimulated by realtors in the same way that banks are fighting retailers. But that is exactly the point. It turns out that whether an activity is financial in nature is not only impossible to resolve as a matter of principle but is also fraught with politics and political pressures. Thus, if the FDIC should ever be so unfortunate as to get the power some in Congress would like to give it, the agency will immediately become embroiled—as has the Fed—in the turf wars between industries with powerful congressional supporters. But by allowing the moratorium to expire on

January 31, 2008, and promptly commencing the process of granting ILC charters to nonfinancial firms, the FDIC will be enforcing the law as written—not an inconsiderable factor—and minimizing the chances that it might be drawn into the politics of industry protection.

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Notes

1. *Competitive Equality Banking Act of 1987*, Public Law 100-86, *U.S. Statutes at Large* 101 (1987): 552.

2. *Gramm-Leach-Bliley Act*, Public Law 106-102, *U.S. Statutes at Large* 113 (1999): 1338.

3. *Congressional Budget and Impoundment Control Act of 1974*, Public Law 93-344, *U.S. Statutes at Large* 88 (1974): 297.

4. See, for example, *Pennsylvania v. Lynn*, 501 F.2d 848 at 852 (D.C. Cir. 1974), in which the secretary of housing and urban development imposed a moratorium on certain rent assistance programs. The court stated: “Whether Congress gave the Secretary the discretion here claimed is preeminently a question of intent.”

5. The discretionary standards on whether to grant deposit insurance are contained in *U.S. Code* 12, § 1816, and focus solely on the depository institution itself: (1) the financial history and condition of the depository institution, (2) the adequacy of the depository institution’s capital structure, (3) the future earnings prospects of the depository institution, (4) the general character and fitness of the management of the depository institution, (5) the risk presented by the depository institution to the Deposit Insurance Fund, (6) the convenience and needs of the community to be served by the depository institution, and (7) whether the depository institution’s corporate powers are consistent with the purposes of this act.

6. Federal Deposit Insurance Corporation (FDIC), “Moratorium on Certain Industrial Bank Applications and Notices,” *Federal Register* 72, no. 23 (February 5, 2007): 5290.

7. FDIC, “Industrial Loan Companies and Industrial Banks,” *Federal Register* 71, no. 163 (August 23, 2006): 49456–59.

8. Joe Adler, “Hurdles Remain for ILC Bill,” *American Banker*, May 22, 2007.

9. Joe Adler and Stacy Kaper, “A Hard Line on Charters, Practices in Dodd ILC Bill,” *American Banker*, November 30, 2007.