

Dodd-Frank Leaves Industrial Banks in Limbo, But Milken Institute Data Show They've Outperformed Other FDIC-Insured Institutions

LOS ANGELES – Should non-financial firms be allowed to own banks? That question was left unanswered by the Dodd-Frank Wall Street Reform and Consumer Protection Act — and today the future of one of the most stable and profitable segments of the banking industry remains in doubt.

Dodd-Frank extended a moratorium on new charters for commercially-owned industrial loan companies (ILCs) that had initially been put in place for all ILCs in 2006. It also directed the Government Accountability Office (GAO) to study whether industrial banks pose any special threat to the stability of the financial system.

A new report from the Milken Institute, “Industrial Loan Companies: Supporting America’s Financial System,” examines the track record of ILCs – including their strong performance during the recent financial crisis – and concludes that they are generally safe, sound and well-regulated.

“Overall, ILCs have operated successfully, serving their customers during the past 20 years, and as a group, they came through the recent crisis in better shape than most other financial institutions,” said James R. Barth, senior finance fellow at the Milken Institute, the Lowder Eminent Scholar in Finance at Auburn University, and lead author of the report. “Our report addresses a major financial issue that truly can change the competitive position of the U.S. in the global financial system.”

Concern over commercial firms owning banking institutions led to the moratorium on new charters for ILCs. Restrictions on such ownership, however, present surprising contradictions:

- Bill Gates can own a bank, but Microsoft cannot.
- Members of the Walton family, major shareholders of Wal-Mart, do own a bank (the Arvest Bank, with some 200 branches in Arkansas, Oklahoma, Missouri, and Kansas), but Wal-Mart cannot.
- Wal-Mart does, however, operate a full-service bank in Mexico and could own banks in most of the foreign jurisdictions in which it operates.

“It seems paradoxical that an individual can own both a bank and a company, and yet that company itself cannot invest in a bank,” added Barth.

Background

ILCs arose in 1910 based on the desire of various companies to organize bank subsidiaries to run an existing financial operation in a more reliable and cost-effective manner, or to develop new financial programs that complement their other business lines. Prior to the moratorium, a handful of states approved charters that allowed

commercial firms to invest in industrial banks, contributing to the availability of credit, and without a single failure. Examples today include ILCs owned by BMW, GE, Pitney Bowes, Target and Harley-Davidson.

The federal moratorium on granting charters to new commercially-owned ILCs was a response to protests against an application by Wal-Mart to form a new ILC in 2005. Some banks and trade associations opposing Wal-Mart's banking plans raised concerns that led to the moratorium and eventually to the GAO's study of the industry.

The GAO will recommend to Congress what should happen to ILCs when the moratorium expires. The Institute's report suggests that barriers should not be erected that impede the ongoing existence and expansion of commercially owned ILCs – and the credit they bring to the market through the capital provided by their parent companies.

Rationale for letting ILCs continue business as usual

ILCs have a track record that underscores the strength of the industry, even after absorbing the impacts of the financial crisis and the recession. The available evidence suggests that ILCs have operated in a safe and sound manner, and as a group they have a lower percentage of troubled assets than the banking industry as a whole. They are significantly and consistently more profitable as well.

- ILCs in aggregate have a significantly higher ratio of capital to assets (16.7 percent) than the banking industry as a whole at 11.3 percent, (all figures based on FDIC data for the third quarter of 2010).
- ILCs have a significantly lower percentage of troubled assets (15 percent) than the banking industry as a whole (31 percent). Commercially owned ILCs in particular have the lowest percentage of troubled assets of all banks (2.35 percent).
- These institutions are significantly and consistently more profitable, with a higher return on assets (2.18 percent), than the banking industry as a whole (0.56 percent). As a group, commercially owned ILCs are the most profitable banks in the nation (with a 2.97 percent ROA).

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ILCs are subject essentially to all of the same restrictions and requirements, regulatory oversight, compliance, and safety and soundness exams as any other kind of bank.

Global competitiveness and capital access

Restrictions on commercial ownership of banks place the United States out of step with most countries around the world. According to World Bank data, only four of 142 countries surveyed prohibit the ownership of banks by commercial firms. The evidence indicates that there is no reason to restrict the ability of the U.S. industrial banking industry to draw upon the substantial equity of commercial firms.

“The total net worth of U.S. non-financial corporate businesses was \$13 trillion as of mid-2010,” added Barth. “If even a small percentage of this capital were invested in the ILC industry, it could contribute to an expansion of available credit, and that in turn could help support the economic recovery.”

The authors of the Institute report caution legislators, regulators and other policymakers not to put the U.S. financial sector at a competitive disadvantage by subjecting ILCs to any additional costly and unnecessary regulation.

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