

**ILC's—A REVIEW OF CHARTER,  
OWNERSHIP, AND SUPERVISION ISSUES**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED NINTH CONGRESS  
SECOND SESSION

—  
JULY 12, 2006  
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Printed for the use of the Committee on Financial Services

**Serial No. 109-106**



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## **ILC's—A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES**

**Wednesday, July 12, 2006**

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
AND CONSUMER CREDIT,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Royce, Lucas, Kelly, Gillmor, Biggert, Miller of California, Hensarling, Garrett, Brown-Waite, Barrett, Pearce, Neugebauer, Price, McHenry, Sanders, Maloney, Sherman, Meeks, Moore of Kansas, Carson, Ford, Crowley, McCarthy, Baca, Green, Clay, Matheson, and Frank.

Chairman BACHUS. Good morning. The Subcommittee on Financial Institutions and Consumer Credit will come to order.

At today's hearing, which was requested by Mr. Leach, we will examine the charter, ownership, and supervision aspects of Industrial Loan Corporations, more commonly known as ILC's. The hearing is not about a particular piece of legislation, nor is it in response to legislation, nor will we be reviewing legislation in anticipation of a markup. It's simply about ILC's, their structure, and their regulation.

Today, there are 61 ILC's in 7 States, with \$155 billion in assets, and \$110 billion in deposits. Although the insured deposits of ILC's has grown by over 500 percent since 1999, those deposits represent less than 3 percent of the FDIC's total insured deposits.

Utah is home to 33 ILC's with approximately \$120 billion in assets; Merrill Lynch Bank is the largest with \$66 billion. California is next, with 15 ILC's and \$17 billion in assets. Most ILC's are owned by financial service companies such as Citigroup, Morgan Stanley, and American Express. Others like GE Capital and GMAC Commercial are within the financial arm of a larger corporate organization. ILC's owned by BMW and Volkswagen support the holding companies' commercial business. Target Corporation, the retailer, has Target National Bank in Utah.

ILC's originated in the early 1900's as small, State-chartered loan companies serving industrial workers who were unable to borrow from commercial banks. Since then, the ILC industry has experienced significant asset growth and has evolved from small, limited purpose institutions to a diverse industry that includes some of the Nation's largest and most complex financial institutions.

In 1982, Congress made ILC's eligible for Federal Deposit Insurance Corporation insurance, becoming subject to FDIC supervision as well as State regulation. In general, ILC's may engage in the same activities as FDIC-insured depository institutions. ILC's offer a full range of loans, such as commercial, consumer and residential real estate, and small business loans.

However, because of the restrictions in Federal and State laws, ILC's do not accept demand deposits or checking accounts but do offer NOW accounts which give the depository institution the right to require at least 7 days notice prior to withdrawal. Like other depository institutions, ILC's may export their home State's interest rates to customers living elsewhere and must comply with the Bank Secrecy Act, Community Reinvestment Act, and various consumer protection laws.

In short, ILC's are subject to the same State banking supervision and FDIC oversight as State banks. Nonetheless, owners of ILC's do not have to be bank holding companies subject to the Federal Reserve's consolidated supervisory authority.

Instead, the FDIC has employed what some call a bank-centric supervisory approach that primarily focuses on isolating the insured institution from potential risk posed by holding companies and affiliates rather than assessing these potential risks systematically across the consolidated holding company structure.

In addition, the Securities and Exchange Commission oversees financial conglomerates known as Consolidated Supervised Entities, several of which own one or more large ILC's, although their main business is in the global securities market. Moreover, in any instance where an ILC and a savings association are affiliated in a corporate structure, the holding company is a savings loan holding company subject to regulation by the OTS. In fact, I believe that 70 percent of the assets of ILC's are regulated by the OTS.

Some argue that this regulatory structure for overseeing ILC's may not provide adequate protection against the potential risks that holding companies and non-bank affiliates may pose to an ILC.

Another area of concern about ILC's is the extent to which they can mix banking and commerce through the holding company structure. A special exemption in current banking law permits any type of company, including a commercial firm, to acquire an ILC in a handful of States. For some, this is the crux of the issue.

I'm sure the separation of banking and commerce will be discussed in today's hearing. There is also likely to be a debate over the fairness of excluding some commercial firms from owning or controlling ILC's after other very similar firms are already engaged in the ILC structure.

In closing, I would like to again thank Mr. Leach, and to thank the Ranking Member, Mr. Frank, as well as Congressman Gillmor, Congressman Royce, and Congressman Matheson for all of their efforts, and for helping us with today's hearing. They are strongly committed to reviewing these issues, and I look forward to working with them and members of this subcommittee as we examine ILC charters.

The Chair now recognizes Mr. Frank, the Ranking Member of the Full Committee.

Mr. FRANK. Thank you, Mr. Chairman. I know that our colleague from Ohio had some other obligations at a markup and I would be prepared to defer to him if he was under the gun to get out.

Chairman BACHUS. Thank you. In fact, Mr. Frank had extended that offer, Mr. Gillmor, and I wanted him to be able to do so as opposed to me.

Mr. GILLMOR. Thank you.

Let me thank the ranking member for doing that. I have a markup on two of my bills in another committee so I appreciate that. And I want to thank you, Chairman Bachus, for calling this important hearing today and for your interest in taking steps to address this important policy area.

We could not be having this oversight hearing at a more critical time. Currently, the FDIC has 14 pending ILC applications for deposit insurance, including applications from some of the largest commercial companies in America. In the past year or so, such diverse commercial firms as Cargill, Daimler-Chrysler, Wal-Mart, and Home Depot have come to the conclusion that they should own and operate a bank. The problem is that they want different and more lenient rules than other companies that own banks.

I think there are many important policy questions at work here but it's my belief that Congress is at a crossroads in financial services regulation. Do we choose to eliminate the historic separation between banking and commerce which has allowed us to avoid the economic pitfalls of Germany and Japan, for example? And if Congress chooses to make that decision, should we make it openly and explicitly rather than simply allowing a loophole in bank law to continue?

Logically, you can't support the use of the ILC loophole without repealing the Bank Holding Company Act that applies to other banks. And hardly anyone would support that position due to the dangers it poses to our financial system. My friend and colleague, Barney Frank, and I have worked on this issue for several years. We know there's no silver bullet or clean fix but we do believe there's a sensible approach to begin to answer this question.

Earlier this week, Congressman Frank and I introduced a comprehensive ILC reform bill. H.R. 5746 would allow the FDIC to act as a consolidated regulator of ILC parent companies, limit the business activities of certain commercially-owned ILC's and, most importantly, establish a cutoff date for commercially-owned ILC's so that Congress can evaluate whether or not to explicitly permit the world's largest retailers to operate full-service national banks.

It's my hope that the future of this charter option will be closely examined by our colleagues on this committee, and I look forward to continuing to work with Chairman Oxley, Chairman Bachus, Ranking Member Frank, my colleague Mr. Leach, and others to make prudent decisions at this fork in the road, and I yield back and I appreciate you yielding.

Chairman BACHUS. Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

The issue, we should be clear, is not, in my mind, and I think in the mind of my colleague who just spoke, whether or not we curtail the ILC model. It is with a limited class of the ILC's—those that are primarily non-financial. The legislation and the approach

that Mr. Gillmor and I have taken borrows from the Gramm-Leach-Bliley approach, the 85 percent, 15 percent metric that says if you're 85 percent financial, you go ahead.

What concerns me is the problem of those entities that are not at all banks owning a bank and the conflicts that are there. Now, it is true when we abolished Glass-Steagall and promoted or recognized, after the fact, the merger, in effect, of banking and securities, there were some concerns about leveraging and tying.

What drove that was the increasing convergence, for a variety of reasons, of the various aspects of the financial services industry, and there were some concerns and some efforts were made to try and limit those problems. I don't see any reason to take that as a precedent for, in effect, throwing open the ownership of banks to entities that are entirely non-financial.

In fact, if we were to go ahead and say, okay, everybody into the pool, you would now have an open season, I guess, for manufacturers, retailers, anybody else, contractors, to own what was in effect a bank. And at that point I'm not sure what value would be served by other restrictions we have.

The other day, I was watching a rerun of, "Are You Being Served", the British comedy about the department store. And Mrs. Slocombe had been dispossessed from her house so she was being given temporary quarters in the home furnishings department of the department store and she felt somewhat exposed to the elements.

So they found a fake door and side panels and put it up in front of her bed so she felt like she was in her house. And then when people came to visit, she would make them come through the door, but the door extended only so far, and on both sides of the door there was wide open space.

It seems to me we're on the verge of doing that with ILC's. I mean, we have all these restrictions that apply if you want to become a bank but it will be like the door to Mrs. Slocombe's apartment because if you want to just own an ILC, you just ignore those and go in anyway.

And here are the problems. This is not artificial. I spoke with the people at Home Depot, a very well-run company. Home Depot is in the district of one of our colleagues who speaks highly of it. I don't doubt their integrity for a minute. Here are the inherent problems.

Home Depot says they're going to buy a bank, and I spoke with them. Now, they have a bank which would have an ongoing relationship with a contractor. If you're a contractor and you have this ongoing relationship, you have a leg up in getting loans for the work you would be doing. People want to have that relationship.

Home Depot says, however, even though the contractor would want to have that relationship with the bank which Home Depot owned, that there would be no pressure whatsoever on that contractor to buy from Home Depot, as opposed to somebody else.

Well, I am sure there are trusting souls who will believe that, and it may even be true, but it is exactly the kind of conflict of interest that we set up walls to prevent. The notion that I'm a contractor and I have an interest in Home Depot continuing to give me this relationship but it's not going to affect where I buy things is tenuous.

You also have this: I'm a homeowner and I want to get a loan so I can do some substantial renovation or repair in my house. Now, I know that if I go to the Home Depot-affiliated contractor, I get a better chance of getting a loan. Not only that, but if I'm the bank, now owned by Home Depot, and someone comes to me for a loan, I have two ways in which I make a profit. One, on the repayment of the loan, but also I understand that if I lend to this individual, he or she may buy a large amount of things from my owner.

And people have said, well, yes, but that's the kind of tie-in that we can prevent. Yes, you can theoretically prevent some of these things but I do not think in practice we ought to create all these problems for the regulators to have to deal with. I think trying to police those relationships on an ongoing basis really would require a degree of intrusive regulation and excessive regulation that's in no one's interest.

What we are talking about is protecting the integrity of the decisions made by banks. They should be made based on the profitability of the loan, and solely on that. When you have a wholly unrelated entity owning the bank, and when that entity can make a profit because the loan is made, because the making of the loan will not only help the bank but will significantly help the owner of the bank, I think the integrity or the purity of that decision is somewhat impugned.

And that's why I believe that in the future we should go with an 85–15 percent test. I would say in closing that if we don't do that, it seems to me what we will then have is the notion that there is something where we have some kind of special status for banks where they are insulated from the other pressures in terms of the loans they make that will simply disappear because if ILC's charters are freely granted, no matter who the owner is, retailer, contractor, manufacturer, racetrack owner, whatever, then I think we have a serious set of regulatory problems that we should not create.

Chairman BACHUS. Thank you. At this time, I'll recognize the senior member of the Financial Services Committee, Mr. Leach, for his opening statement.

Mr. LEACH. Thank you very much, Mr. Chairman.

I want to express my personal admiration for all you've been doing in this Congress on banking issues. I'm deeply impressed and I appreciate your inviting me to come today to your subcommittee.

It's self-evident that Congress must act to revamp the regulatory oversight of ILC's. The simplest and most comprehensive approach is to require that an ILC become a financial holding company obligated to comply with all of the conditions, requirements, restrictions, and limitations that apply to a financial holding company under the Bank Holding Company Act.

This approach, which I have introduced in this Congress as H.R. 3882, is the exact bill I have introduced to numerous prior Congresses dating back to the 1990's. It was initially objected to because ILC's were considered small irrelevant footnotes in American finance. But as Chairman Bachus has just noted, the ILC industry has experienced significant growth over the past several decades.

Now, more behemoth commercial companies are pressing the commerce banking envelope and this trend is likely to escalate and include greater numbers of foreign actors.

As this Congress well understands, Congress has explicitly forbidden banks from engaging in commercial endeavors. Implicitly, it is irrational to think that a commercial company, by buying or establishing a banking-like institution such as an industrial loan company, should be able to do what Congress prohibited in reverse. What was prohibited in one direction should not be sanctioned in another.

There are four broad attempts of financial modernization legislation known as Gramm-Leach-Bliley: one, to enhance three-way competition between the banking, securities, and insurance industries; two, to create functional regulation by category of activity; three, to establish a principal umbrella regulator to ensure that regulatory cracks are filled; and four, to curtail regulatory arbitrage at the Federal level.

This fourth point is seminal to the discussion at hand. In developing compromises to make Gramm-Leach-Bliley possible, I fully understood that private sector industries had rival interests and that maximization of profit was a respectable motivation in a free market economy. But I was continually surprised at the intensity of bureaucratic rivalries and had minimal respect for the maximization of power motivation of public sector institutions.

It is in this context that I'm concerned that regulatory power rivalry may resurface in the ILC issue. As a primary Federal regulator of ILC's, the FDIC has the potential to empower commercial companies and, in so doing, aggrandize its own regulatory jurisdiction. But Congress's goal in GLB was to protect the public interest by establishing cooperative rather than confrontational relationships between regulators.

Although the FDIC is critically important in the Federal regulatory regime, it is not intended to be an exclusive authority. The Congress concluded in GLB that consensus institutional decision-making was vastly preferable to regulatory arbitrage.

In an extensive review I requested last year, the General Accounting Office pointed out that when the Federal Reserve is deprived of a regulatory role, significant gaps in oversight can occur. The FDIC, after all, has limited experience in holding company oversight and, vastly more importantly, lacks the legal right to review the financial well-being of holding companies.

Under a Bank Holding Company Act framework, from which ILC's are currently shielded, the Federal Reserve is empowered to establish consolidated capital requirements to ensure that holding companies are a source of financial strength for a subsidiary bank.

Under the Bank Holding Company Act, commerce and banking cannot be merged. Where financial companies have holding companies, the Federal Reserve has broad enforcement authority. It can issue cease and desist orders, impose civil penalties, and order a holding company to vest non-bank subsidiaries if it determines that ownership of the subsidiary presents a risk to the financial safety, soundness, or stability of an affiliated bank and is inconsistent with sound banking principles.

Corporate parents of ILC's are not subject to these requirements. In our marked economy, seldom is short-term viability a guarantor of long-term financial strength. Without the safeguard controls that exist under the Bank Holding Company Act, it's problematic for the government to prevent deficiencies and damage to the Federal safety net.

More profoundly, it's problematic to envision the consolidation of ownership and other changes in the nature of our economy which will occur if banking and commerce are integrated. There is, after all, a catch-22 dilemma in allowing commercial companies to own federally-insured financial institutions such as ILC's. Commercial companies which are weak or become weak could easily develop conflicts that jeopardize the viability of a federally-insured institution. On the other hand, those which are strong could too easily precipitate chain reaction consolidations of ownership or tilt the competitive marketplace in anticompetitive ways.

Finally, a note about the bizarre circumstance that ILC's are limited by law to only a handful of States. The effect of this legal situation is that the specially empowered States have a vested interest in approving ILC charters which may be foreign as well as domestic—

Chairman BACHUS. Mr. Leach, you could—

Mr. LEACH. I have just about 1 more minute if that's all right with the Chair.

Chairman BACHUS. You can stay on.

Mr. LEACH.—despite the fact that certain charters might fly in the face of Federal precedent and good government practices. The concentration of ILC's in a few States has the effect of taking jobs from the majority of States as well as the prospect of changing the nature of the American economy.

In conclusion, let me stress that due to aspects of current economic circumstance and the obligations of Congress with regard to financial industry supervision, the United States today confronts unprecedented challenges. The twin fiscal and trade deficits are compounded by war on several fronts. It has eroded support for America and the world and by an escalation in petroleum prices which constrains the disposal income of the American family and thus GDP in general.

This is why a straightforward, comprehensive approach of requiring an ILC to become a financial holding company with all of the obligations implicit in the Bank Holding Company Act is so preferable to the compromise approaches on the table.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Leach. Mr. Sanders?

Mr. SANDERS. Thank you, Mr. Chairman.

Let me concur with Mr. Leach, and praise him for the work that he has done on this issue. Also, Mr. Chairman, I would like to ask unanimous consent that the statements of the National Community Reinvestment Coalition and the Sound Banking Coalition be included in the record of this hearing.

Chairman BACHUS. Without objection.

Mr. SANDERS. Thank you.

Mr. Chairman, this is an important hearing. Thank you very much for holding it. What we are examining today is an enor-

mously important issue and that is whether we continue our country's strong tradition of separating banking from commerce or do we allow a loophole in current law to expand that could permit retailing giants like Wal-Mart and others to own banks all across America.

Mr. Chairman, let me be clear that I am strongly opposed to allowing Wal-Mart and other non-banking conglomerates to receive industrial loan charters. In that regard, I have co-signed a letter authored by Mr. Gillmor and Ranking Member Frank urging the FDIC to impose a moratorium on approving any ILC applications owned by commercial firms. I am glad that Douglas Jones from the FDIC is here today and I hope that he will be receptive to imposing this moratorium.

If Wal-Mart, Home Depot, and other large corporations are allowed to become ILC's, they will be granted similar privileges as regular banks without the same regulatory oversight. This is wrong and could have very serious ramifications to our economy, particularly in rural areas.

According to a study by Iowa State University, up to 47 percent of local retailers in some small towns are forced out of business within a decade after Wal-Mart opens up a store in their area—up to 47 percent. But that figure could skyrocket even higher if Wal-Mart is allowed to own banks in thousands of their stores all across this country.

First, Wal-Mart would drive many small community banks in rural areas out of business. Then Wal-Mart may refuse to lend to their local competitors, forcing them to close their doors. This could provide Wal-Mart with monopoly control over small towns throughout this country. And in that regard, Mr. Chairman, I would like to quote from the statement of the National Community Reinvestment Coalition.

This is what they say, and I quote: "Mixing banking and commerce imperils safety and soundness because it eliminates a bank's impartiality. A bank with a commercial affiliate will not base its lending decisions on sound underwriting criteria. Instead, it will favor its affiliate and cut off credit for its competitors. The bank will also be tempted to finance its affiliates' speculative and risky ventures. With a bank the size of Wal-Mart or Home Depot, the end result is a significant reduction in credit for independent small businesses and an increase in financing for the bank's affiliate regardless of the risk it produces".

Mr. Chairman, small businesses and community banks are the backbone of our rural economy. In my opinion, we must not jeopardize the very survival of these businesses by expanding the ILC loophole.

Mr. Chairman, on this issue I am in complete agreement with the Independent Community Bankers of America, the United Food and Commercial Workers, the National Grocers Association, the National Association of Convenience Stores and the National Community Reinvestment Coalition. We must end the ILC loophole once and for all.

To that end, I want to commend Mr. Leach for his legislation that he has recently introduced to close the ILC loophole by requiring any company that owns or would like to own an ILC to sell off

their non-financial activities. This legislation would also require ILC's to undergo the same regulation and supervision by the Federal Reserve that applies to all other banks. I am convinced this is the correct approach to take.

However, I also understand that Mr. Gillmor and Mr. Frank have introduced compromise legislation that would, among other things, prohibit commercial firms from acquiring industrial banks effective June 1, 2006. I applaud Mr. Gillmor and Mr. Frank for introducing this legislation and look forward to working with them as the chairman on this extremely important issue.

The separation of banking and commerce has served our country well. We must keep the separation intact by passing either the Leach bill or the Gillmor-Frank bill.

I thank the Chair and I look forward to hearing from our witness.

Chairman BACHUS. Thank you, Mr. Sanders. We have nine other members who want to make opening statements and I'm going to suggest—we have two of those members who were among the members that actually made the written request for the hearing, and that's Mr. Royce and Mr. Matheson. And I would not want to limit their time, but if we could have an agreement—I don't know—Mr. Matheson, Mr. Royce, how long are your opening statements? How long are they?

Mr. ROYCE. I'd say—would 4 minutes be fair?

Chairman BACHUS. Four or five—if it's—if the other members would consent to giving them their full 5 minutes, letting the other members have 2 or 3 minutes, try to limit theirs to—

Mr. SHERMAN. Sounds good.

Chairman BACHUS. And if you all will agree, I would like to recognize them next as the requesting members, and go to Mr. Royce, then to Mr. Matheson and then we'll go back to the regular order.

Mr. ROYCE. Thank you very much, Mr. Chairman. I appreciate that and I thank you again for holding this hearing to review the charter and ownership and supervision issues related to ILC's. And I'd also like to thank our—I think we're going to have a total of 10 witnesses today—for their testimony this morning.

While ILC's have been in existence, I guess, for about 100 years, it is only recently that the charter has gained a great deal of attention and I believe a review of that charter is a healthy exercise for this committee. In fact, I've called for such hearings many times in the past.

Industrial Loan Companies are regulated in a similar manner to all other federally-insured depository institutions. For example, they are subject to the same minimum capital and prompt corrective action provision as any other bank we're familiar with in this committee.

Some critics have expressed concern that an ILC might be used to subsidize a parent company's cost of capital. However, the rules for dealing with affiliates first prescribed in Sections 23A and 23B of the Federal Reserve Act apply to all FDIC-insured and depository institutions. This means that an Industrial Loan Company's relationship with any affiliates is subject to very strict rules.

Under Section 23A, an ILC's total covered transactions with any affiliate cannot exceed 10 percent of the bank's capital. The ILC's

total covered transactions with all affiliates combined cannot exceed 20 percent of the bank's capital. With few limited exceptions, covered transactions must be fully secured with qualifying capital and an ILC cannot purchase a low quality asset from an affiliate.

Under Section 23B, an ILC must deal with an affiliate on market, in other words, at arms-length, in terms of arms-length terms. An ILC cannot, as a fiduciary, purchase securities or other assets from an affiliate unless otherwise permitted by statute or court order. The ILC cannot, as principal or fiduciary, purchase particular securities while an affiliate is a principal underwriter for those securities. And, lastly, neither the ILC nor its affiliate may publish any advertisement or make any agreement stating or suggesting that the ILC shall in any way be liable for the obligations of its affiliate.

Other critics have suggested that the ILC regulatory structure is deficient because some ILC parents are not subject to supervision at the holding company level. In the past, the FDIC and the State banking regulators with oversight of ILC's have suggested that they have sufficient powers to regulate the parent-ILC relationship. I'm interested to hear more about this concern from our witnesses this morning.

Furthermore, I'd like to introduce into the record a letter from SEC Chairman Cox in which he outlines the Commission's powers and authority under the Consolidated Supervised Entity regime. An overwhelming majority of total ILC assets are subject to the Consolidated Supervised Entity regime to supervision under this and from regulators such as the SEC and the OTS.

Mr. Chairman, thank you again for holding this hearing and I look forward to hearing from our witnesses.

I yield back.

Chairman BACHUS. Thank you, Mr. Royce. And I indicated—I want to correct myself. I had indicated that Mr. Matheson and Mr. Royce actually requested this hearing. They did not request this hearing. What they requested was that, if this hearing was held, they be allowed to participate in the suggestions for witnesses and the structuring of the hearing. So I wanted to make that qualification.

Mr. Matheson.

Mr. MATHESON. Thank you, Mr. Chairman, for holding this hearing on the industrial bank charter and the framework in which industrial banks are regulated at the State and Federal level. It's my hope that this hearing is going to be a constructive opportunity for the subcommittee to focus on factual information and legitimate policy issues regarding the regulation of ILC's.

And I hope members of the committee will set aside preconceived notions and take the time to listen and learn about the supervision of ILC's rather than discussing issues outside the direct scope of this hearing, such as bills introduced by ILC opponents or applications for ILC charters not approved or even accepted by the State banking regulator. I think members will come to value the competition of benefits these institutions provide to millions of consumers and business around the country.

I hope the members will learn in this hearing what ILC's are and what they are not. While many critics and competitors of ILC's

argue that these institutions are not subject to comprehensive regulation, they are in fact subject to not only regulations and supervision by their respective State banking regulators but also by the FDIC and, in many cases, subject to consolidated holding company regulation by the Office of Thrift Supervision and the SEC.

Industrial banks are subject to all the Federal banking laws that apply to other FDIC-insured State charter banks, including consumer protection requirements, restrictions on transactions with affiliates, depository reserve requirements, safety and soundness requirements, and Community Reinvestment Act requirements.

Some ILC competitors have argued that these banks pose a threat to the safety and soundness of the national banking system. As a group, industrial banks are better capitalized and better rated than other banks. Former FDIC Chairman Powell asserted that ILC charters, "pose no greater safety and soundness risk than other charter types." And in fact, the much-mentioned report issued by the Government Accountability Office last year said that, "from an operations standpoint, ILC's do not appear to have a greater risk of failure than other types of depository institutions."

Those who criticize ILC's also argue that these banks allow for the inappropriate mixing of banking and commerce. ILC's cannot engage in any activity not approved by their regulator, nor can they engage in any activity not permitted for other insured depository institutions. They're subject to Sections 23A and 23B of the Federal Reserve Act which severely restricts transactions between a bank and its parent company.

The fact is that it's questionable if there is a bright line now between banking and commerce. Gramm-Leach-Bliley Act actually liberalized the ILC charter and authorized commercial banks to engage in a number of formerly prohibited non-banking commercial activities.

Finally, there are those who claim that ILC's exist only by virtue of a loophole. It is, in fact, the law that allowed the formation of ILC's almost 100 years ago, and it is the law that has allowed the 33 active industrial banks operating in Utah and holding over \$120 billion in assets to do well in a competitive market today.

ILC opponents claim that a loophole exempts these banks from bank holding company regulation by the Federal Reserve. In fact, Congress expressly exempted the parent companies of industrial banks from the Bank Holding Company Act with the enactment of the Competitive Quality Banking Act in 1987. The exemption was debated before it was enacted, and Congress hasn't modified the exemption since it became law almost 20 years ago.

So in closing, Mr. Chairman, I do want to thank you for holding this hearing today. I hope that the facts speak for themselves and I hope that when the hearing is over, members will have a better appreciation for the facts surrounding industrial banks, including their strong record of effective regulation by State and Federal Governments, their history of industry success, and their role in providing greater competition and efficiency to our economy.

I yield back my time.

Chairman BACHUS. Thank you, Mr. Matheson. Mr. Pearce.  
Mr. PEARCE. Thank you, Mr. Chairman.

Just briefly, being from a rural State—a vast rural State with lots of dirt between voters—my greatest concern is that consolidation tends to argue or work against the small rural States. Consolidation always—and funds should always seek the highest rates of return. The rates of return on loans and investments in New Mexico will never be what they are in Washington, D.C. The price of one of the houses along the Potomac could probably buy all of the homes in some of the counties in my district; that does not mean that we should not have access to capital and consolidation leads to a limitation and non-availability of capital in those area of low rates of return.

As we look at the world and the Nation's economy, we must be aware that our economy cannot thrive and survive with just 20 or 30 large metropolitan areas. We do need to be aware of the areas where small rural banks will invest in their local economies but never get the rates of return that could be achieved in other areas. So I'm greatly concerned about that.

On the other side of the fence, business, and Wal-Mart specifically, because they seem to be the focus of this discussion, deserve fairness. They deserve predictability and I arrive at the same conclusion that Mr. Gillmor did, that it's time for a very thorough look at the entire way that we are granting charters, the way that we're doing banking, the way that we're doing the ILC's in this country. It's way overdue to look at the way that regulators are affecting the situation.

So I appreciate you having this hearing. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Pearce. Mr. Sherman, thank you; we appreciate your patience.

Mr. SHERMAN. Thank you, Mr. Chairman. I want to join the gentlemen from Ohio, Massachusetts, Iowa, and Vermont, and associate myself with their statements.

As so many have stated, we cannot and should not mix banking with commerce. Because I strongly believe in the importance of maintaining that separation, I have opposed the Wal-Mart ILC application. Quite a number of members of this committee signed a letter on December 15th to the FDIC asking for a moratorium on new approvals for new commercially-owned ILC's until the FDIC board was fully constituted.

Quite a number of us also joined in a June 8th letter to the FDIC asking for a moratorium on new approvals for new commercially-owned ILC's until Congress gets a chance to consider this matter. By consider this matter, I would think not only hold this particular subcommittee hearing, but actually consider the legislation put forward by Mr. Leach or the bill put forward by Mr. Frank and Mr. Gillmor.

Without objection, I'd like to put those two letters into the record of this hearing.

Chairman BACHUS. Without objection.

Mr. SHERMAN. We took a giant step when we passed Gramm-Leach-Bliley and said that the walls that separated banking from other financial activities would be swept aside. I think that it is best for us to see how our economy reacts to that dramatic change before we allow the ILC's to go from a real small part of our econ-

omy to a new device to break down all the walls between banking and commerce.

We ought to see how Gramm-Leach-Bliley works, how this massive expansion of the activities that can be linked with banking works before we go down the road of the Japanese model of linking banking and finance. It is important that capital be allocated fairly and efficiently, especially if that capital is created through Federal insurance. And as Mr. Frank pointed out, there is certainly the risk that an ILC will favor its parents, suppliers, customers, or potential customers and, in some cases, perhaps its parent entity itself.

So I look forward to not only these hearings but hopefully a markup of legislation, and I would hope that the FDIC would take no action until Congress has a chance to consider such legislation.

I yield back.

Chairman BACHUS. Thank you, Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman. Thank you for holding this hearing. I appreciate the opportunity for us to discuss in this Congress the future of the Industrial Loan Corporations.

This has been a growing interest in commercial enterprises entering the insured banking business and this has resulted in a significant increase in ILC assets over the last 20 years. The mounting concern that comes from this growth is certainly justified but while it supports the competitive spirit intrinsic in expansion, it's imperative that we don't allow a competitive advantage or disadvantage to take hold in the marketplace.

And as public policymakers, it's important that we achieve that balance so that there is competition within the marketplace, that there are no public policy advantages or disadvantages given to different sectors. And so I think it's important that we have a very balanced approach when it comes to ILC's.

And as someone who has not made my mind up in regards to how we approach this or what the proper approach is, rather, I think it's important that we, here in Congress, listen to what we can come up with from the two wonderful panels we have here today and through ongoing discussions about the best way to approach this to achieve a proper balance in the marketplace.

So, Mr. Chairman, thank you so much for taking the time to have this hearing. I appreciate the panelists being here today as well as a small crowd.

Mrs. KELLY. [presiding] Thank you, Mr. McHenry.

Mr. Moore.

Mr. Moore, you have no opening statement?

Ms. Carson, do you have an opening statement?

Ms. CARSON. I do not have an opening statement but I would like to request that my statement—go into the record for—

Mrs. KELLY. Yes. So moved. Mr. Crowley?

Mr. CROWLEY. I thank the gentlelady for yielding and I appreciate the committee holding this important hearing today on Industrial Loan Corporations.

First, let me say that while I may disagree with the ranking member of the Full Committee on this particular issue, I believe he has not tried to demagogue this issue or some of the corporations at play, but has a true philosophical opposition to the expan-

sion of ILC's. I respect his opinion as much as I respect him, but on this issue we disagree.

I support ILC's because I do not believe they present any risk to the safety and soundness of our Nation's banking system. They will provide greater competition in the marketplace for consumers and because I fear that an idea that should be debated in a rational way may be being argued by some opponents using a major American retailer as a sort of evil face of ILC's.

With respect to the safety and soundness issue, there's been no evidence presented to me to date of an ineffectiveness or weak supervision by the FDIC or current ILC's as some claim. Furthermore, current ILC's operating have posted no risk, either individual or systematic, to the Nation's banking system.

Secondly, ILC's will also provide greater competition in the Nation's banking system which is, I believe, a positive. These ILC's will provide greater competition to the banking industry which will also help consumers. In fact, some opponents of ILC's happen to be the chieftains of capitalism arguing essentially that they oppose ILC's for the fear of new competition they will bring.

And finally, I fear that an idea that should be debated on its merits, whether we should expand ILC's or not, and on which both sides have reasonable arguments, some people are using this issue as a red herring of sorts to beat up on a particular retailer or retailers, trying to obtain FDIC permission to create an ILC.

Some argue that some of these retailers are bad on other issues and this should be used as a stick to punish them. But I think, while appreciating their arguments and not necessarily disagreeing with some of their arguments, that their overall argument is flawed, and that allowing an ILC to continue will provide new competition and help the very people these groups represent.

But again, I am pleased that we're having this hearing so that we may discuss the issues of ILC's and Congress's role and whether we should stop them or not. And before I yield back, I've been asked by Mr. Matheson if I would enter into the record a letter from the Office of Thrift Supervision, Department of the Treasury, into the record, Madam Chairwoman.

Mrs. KELLY. So moved.

Mr. CROWLEY. And with that, I yield back the balance of my time.

Mrs. KELLY. Thank you. Actually, I'm next on the list so I'm going to make an opening statement.

I want to echo my colleagues' concerns about safety and soundness with regard to ILC's. I've always been concerned that ILC's represent a dangerous exception to our banking laws by placing a disproportionate share of our Nation's financial assets into small State regulators with a financial interest in attracting business away from established regulatory centers like New York or Chicago.

Wall Street firms are regulated by the SEC and the FDIC as well as State regulators and when you look at the number of people in—the number of ILC's in Utah, it's a small State. The ILC's are growing and I'm concerned that the Utah banking department doesn't have the resources to accomplish its regulatory job.

I'm very concerned that the entire list of the staff of the Utah financial institution department can fit on one page, in large type. I'm asking the committee to place that page in the record so the public can know how small the Utah ILC regulatory force is.

In New York State, there's 438 examiners for a level of \$900 million assets for each examiner. In Utah, there are 36 examiners for a level of \$3.1 billion in ILC assets alone per examiner, and that does not include all the small banks and credit unions in the State that also need regulation. I wonder if that's going to be enough regulation and I'm very concerned about whether the regulation is enough to hold the safety and soundness issues that we are concerned with back from being a problem in the States that have the ILC's.

So I will, with unanimous consent, put this in the record and yield back the balance of my time, and turn now to Ms. McCarthy.

Mrs. MCCARTHY. Thank you. I don't have an opening statement. I'm looking forward to hearing from the witnesses.

Mrs. KELLY. Thank you, Ms. McCarthy. Mr. Baca.

Mr. BACA. Thank you, Madam Chairwoman. I want to thank you for holding this important hearing.

While this hearing is about the ILC's in general, the impact of Wal-Mart pending the ILC's application will be felt in our districts and our communities across the Nation. For this reason, the application was a subject of two FDIC hearings in April and is a source of considerable debate across the country today.

Federal Reserve Chairman Ben Bernanke, and former Federal Reserve Chairman Alan Greenspan, had publicly opposed the ILC's loopholes in underscoring the reasons for a full Congressional review of the issues surrounding the ILC's. I am pleased that the FDIC postponed pending ILC's application, giving us a chance to examine this issue further.

Other commercial firms like Target, General Motors, and General Electric own ILC's; however, there are many questions that are left unanswered about the impact of these companies entering into the banking business.

Does the FDIC have enough supervision or authority over the ILC's to uphold the safety and soundness of the banking system, is question number one. Will we begin to see communities' banks closed in the same way that local businesses have been driven out by the Wal-Mart superstores? What will this mean for the underserved communities? Will low income consumers have access to capital and fair lending, which is very important for a lot of us as we look at our diversity and growth within our communities. And I know in the empire we probably don't have the biggest wealth in that area but how it would impact us in that area.

I look forward to hearing from some of the witnesses today, and hope that their input will help us better determine appropriate steps we should take in moving forward on this and other ILC applications.

I thank you, and I yield back the balance of my time, Madam Chairwoman.

Mrs. KELLY. Thank you, Mr. Baca. Ms. Brown-Waite.

Ms. BROWN-WAITE. Thank you, Madam Chairwoman. I certainly appreciate the subcommittee holding this hearing.

America has had a long history of keeping banking and commerce separate. This philosophy has actually protected our Nation from giant conglomerates controlling the financial markets, and enforcing the hands of the economy in their favor. This philosophy was strongest after the Great Depression, not that I was around for it, but I'm told that it was, when our government fought against major monopolies and won. Allowing a worldwide giant like Wal-Mart to provide banking services to millions of employees and consumers would throw us right back into that fight.

Florida is not home to any ILC's. In their absence, community banks, farm credit organizations, and credit unions provide specialized services to their unique client base. In rural areas like my Congressional district, a farmer can get a loan for new tractor equipment, while a local restaurant can reinvest their profits to open up a new location, and a young family can begin a savings and investment plan to meet college needs.

This diversity can only be met by local financial planners and advisers who know their clients. Therefore, saying that I'm troubled by Wal-Mart's ILC application is an understatement. Nervous, nauseous, and almost terrified, is more like it.

I certainly look forward to hearing what our witnesses have to say today on this issue and again, Madam Chairwoman, I appreciate having this hearing so that we can have a public record about this issue.

Thank you, and I yield back.

Mrs. KELLY. Thank you. Mr. Ford, do you have an opening statement?

Mr. FORD. I do not. I would subscribe to the notion that since we have panelists we ought to listen to them, so I'm going to wait and let them talk.

Mrs. KELLY. In that case, we will introduce the witnesses and let's hear from them.

We have first Mr. Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System. Next, Mr. Douglas H. Jones, Acting General Counsel, Federal Deposit Insurance Corporation. Next we have Mr. Edward Leary, Commissioner for the Utah Department of Financial Institutions and, finally, Mr. Rick Hillman, Director, Financial Markets and Community Investment, the United States Government Accountability Office.

We welcome you, gentlemen, and look forward to your testimony. We will begin with you, Mr. Alvarez.

**STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL,  
BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM**

Mr. ALVAREZ. Thank you, Madam Chairwoman, Representative Frank, and members of the subcommittee. I am pleased to testify on behalf of the Board regarding Industrial Loan Companies or ILC's and I ask that my full statement be incorporated into the record.

ILC's are State-chartered banks that have access to the Federal safety net and virtually all the powers of insured commercial banks. Nevertheless, a special exception in the Federal Bank Holding Company Act allows any type of firm, including a commercial firm or a foreign bank, to acquire an Industrial Loan Company

chartered in one of a handful of States without Federal supervision of the parent holding company and without any restriction on the scope of activities conducted by the bank's affiliates.

At the time the ILC exception was adopted in 1987, ILC's were mostly small locally-owned institutions that had only limited deposit taking and lending powers under State law. Today, however, this exception has become the means through which large commercial, industrial, retail, and other firms may acquire an insured bank and gain access to the Federal safety net.

Indeed, the changes that have occurred with ILC's in recent years have been dramatic. For example, while the largest ILC in 1987 had assets of less than \$400 million, the largest ILC today has more than \$60 billion in assets, and \$54 billion in deposits, making it the twelfth largest insured bank in the United States in terms of deposits.

The ILC exception is open-ended and subject to very few statutory restrictions. Only a limited number of States may charter exempt ILC's. However, there is no limit on the number of ILC's that these grandfathered States may charter going forward and Federal law allows new or existing ILC's to offer a wide range of insured deposit, lending, payment-related, and other banking products and services.

The Board is concerned that the recent and potential future growth of ILC's threatens to undermine two important policies established by Congress; one, concerning the separation of banking and commerce, and the other concerning the proper supervisory framework for companies that own a federally-insured bank.

For many years, Congress has sought to maintain the general separation of banking and commerce. Congress reaffirmed this policy several times, most recently in 1999 in the Gramm-Leach-Bliley Act when it closed the unitary thrift loophole which previously allowed commercial firms to acquire a federally insured savings association.

In the GLB Act, Congress also created the concept of financial holding companies and allowed those companies to engage as a general matter only in financial activities and it allowed a financial holding company to affiliate with a full-service securities or insurance firm only so long as the company's subsidiary depository institutions remained well capitalized and well managed and maintained at least a satisfactory CRA record.

The ILC exception undermines each of these policies. It allows commercial and financial firms to operate insured ILC's without complying with the activity restrictions established by Congress for the other corporate owners of insured banks. It also allows financial firms to acquire an insured bank without meeting the capital, managerial, and CRA requirements applicable to financial holding companies.

In addition, the ILC exception allows firms to avoid the supervisory framework that Congress has established for the corporate owners of insured banks. On this point, let me be clear that the Board has no concerns about the adequacy of the supervisory framework governing ILC's themselves. However, unlike the parent company of an ordinary bank, the parent company of an ILC is not considered a bank holding company and is not subject to Federal

supervision on a consolidated basis under the Bank Holding Company Act.

This creates a supervisory gap because the supervisory authority over bank holding companies and their non-bank subsidiaries under the BHC Act is significantly broader than the supervisory authority that the primary Federal supervisor of an ILC has with respect to the holding company and non-bank affiliates of the ILC.

This gap exists for foreign banks as well. In 1991, Congress made consolidated supervision a prerequisite for foreign banks seeking to acquire a bank in the United States. This is a trend in supervision that is growing worldwide. The ILC exception, however, allows a foreign bank that is not subject to consolidated supervision in its own country to evade this requirement and acquire an insured bank in the United States.

The Board applauds the subcommittee for holding this hearing on these important issues. The Board believes that the Nation's policies on banking and commerce and the framework for supervision of federally insured banks and their affiliates are important. These are policies that have shaped, and will continue to shape, the structure and development of our Nation's financial system and the economy.

The Board believes that the decisions on these important policies should be made by Congress acting in the public interest after deliberate and careful consideration and not through the exploitation of what was intended to be a limited exception.

I'd be pleased to try to answer the committee's questions.

[The prepared statement of Mr. Alvarez can be found on page 80 of the appendix.]

Mrs. KELLY. Thank you, Mr. Alvarez. Without objection, all of the panel's written statements will be made part of the record and each of you are recognized for 5 minutes.

I didn't feel the need to describe the lights. I believe that you have all testified here before. You know what the light systems are—red, yellow, and green. So let's go on to the next witness.

Mr. Jones.

**STATEMENT OF DOUGLAS H. JONES, ACTING GENERAL  
COUNSEL, FEDERAL DEPOSIT INSURANCE CORPORATION**

Mr. JONES. Thank you, Madam Chairwoman.

Madam Chairwoman, Representative Frank, and members of the subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning Industrial Loan Companies. Although I cannot comment on specific pending applications, my testimony this morning will discuss the history and characteristics, current industry profile, and supervision of ILC's.

Industrial Loan Companies and industrial banks are State-chartered banks supervised by their chartering States and the FDIC, their primary Federal regulator. The ILC's have existed since 1910. The FDIC has been involved in the supervision of ILC's since it first insured banks in 1934. The modern evolution of ILC's began in 1982 with the passage of the Garn-St Germain Depository Institutions Act, which expanded ILCs' eligibility to apply for Federal deposit insurance.

Shortly thereafter, in 1987, the Competitive Equality Banking Act clarified which institutions would be subject to the Bank Holding Company Act, exempting any company that controls one or more ILC's from the BHC Act generally if the ILC met certain conditions specified by statute.

ILC's comprise a relatively small share of the banking industry, numbering less than 1 percent of the total 8,790 insured depository institutions and 1.4 percent of the assets. As of March 31, 2006, there were 61 insured ILC's with 48 of the 61 operated from Utah and California. ILC's also operate in Colorado, Hawaii, Indiana, Minnesota, and Nevada. California, Nevada, and Utah are the most active in chartering ILC's.

The powers of the ILC charter are determined by the laws of the chartering State. Typically, however, an ILC may engage in all types of consumer and commercial lending activities and all other activities permissible for insured State banks.

ILC's are owned by a diverse group of financial and commercial firms. Of the 61 existing ILC's, 43 are either independently owned or affiliated with a parent company whose business is primarily financial in nature. These 43 ILC's comprise approximately 90 percent of the ILC industry's assets and deposits. The remaining 18 ILC's are associated with parent companies that can be considered non-financial. They account for approximately 10 percent of the ILC assets and deposits.

The largest ILC, Merrill Lynch Bank, on its own holds approximately 40 percent of ILC assets and 48 percent of ILC deposits. Among the ILC's associated with firms that can be considered non-financial, GMAC Commercial Mortgage Bank is the largest, holding just under \$4 billion in assets and accounting for 2.6 percent of ILC industry assets and 2.9 percent of ILC industry deposits.

Today, the assets in ILC's are approximately \$155 billion. This reflects growth from \$4.2 billion in 1987. Four financial services firms alone accounted for over 60 percent of this growth.

ILC's have a good safety and soundness record to date. Overall, the FDIC's examination experience with ILC's has been similar to the larger population of insured institutions and the causes and patterns displayed by problem ILC's have been like those of other institutions. The authorities available to the FDIC to supervise ILC's have proven to be adequate thus far for the size and types of ILC's that currently exist.

Recognizing the dynamic nature of the ILC industry, however, the FDIC is examining whether additional authorities could prove useful in ensuring the safety and soundness of these institutions.

ILC's are supervised by the FDIC in the same manner as other State non-member banks. They are subject to regular examinations, including examinations focusing on safety and soundness, consumer protection, community reinvestment, information technology, and trust activities. ILC's are subject to FDIC rules and regulations as well as restrictions under the Federal Reserve Act governing transactions with affiliates and tying practices.

Just as for all other insured banks, ILC management is held accountable for ensuring that all bank operations and business functions are performed in a safe and sound manner and in compliance with Federal and State banking laws and regulations. Four of the

largest and most complex ILC's are subject to near-continuous on-site supervision.

The primary difference in the supervisory structures of the ILC's and other insured financial institutions is the type of authority over the parent organization. The Federal Reserve and the OTS have explicit supervisory authority over bank and thrift holding companies, including some holding companies that currently own ILC's.

The FDIC has the authority to examine affiliate relationships with the ILC, including its parent company and any other third party, as may be necessary to determine the relationship between the ILC and the affiliate, and to determine the effect of such relationship on the ILC.

The FDIC also possesses a variety of authorities to restrict or prohibit a supervised institution from engaging in activities with an affiliate or any third party that may cause harm to the insured institution. Actions can range from civil money penalties to divestiture in appropriate circumstances. The FDIC has the authority to enforce conditions or written agreements that apply to ILC's and their parent organizations.

The FDIC generally follows the same review process for applications for deposit insurance and notices of changes of control relative to ILC's as it does for such requests from other applicants. Decisions whether to impose specific conditions are based upon the totality of the application and investigation, and may consider such issues as the complexity and perceived risk of the business plan, adequacy of capital management, relationships with affiliated entities, and sufficiency of risk management programs, among other considerations.

This concludes my statement. The FDIC appreciates the opportunity to testify regarding the profile and supervision of ILC's and I will be happy to answer any questions the subcommittee may have.

[The prepared statement of Mr. Jones can be found on page 148 of the appendix.]

Mrs. KELLY. Thank you, Mr. Jones.

Mr. Leary.

**STATEMENT OF G. EDWARD LEARY, COMMISSIONER, UTAH  
DEPARTMENT OF FINANCIAL INSTITUTIONS**

Mr. LEARY. Good morning, Madam Chairwoman, and members of the subcommittee. Thank you for the opportunity to testify on industrial banks.

I'm Edward Leary, the Commissioner of Financial Institutions for the State of Utah. I've been involved with banking for 32 years, first as a community banker, then 15 years in bank examiner positions with the Utah Department, and for the last 14 years as its commissioner.

The choice of charter remains a vital component of the checks and balances of the dual banking system. State-chartered institutions, in attempting to survive and meet the needs of their customers, have fostered creativity and experimentation. State-chartered institutions can innovate in a controlled environment that limits systemic risks.

Dual banking is built upon the ability to freely choose the supervisory structure under which the insured entity operates. This foundation contributes to a competition and excellence amongst the financial institution regulators. If I was invited to participate in this hearing today because of Utah's history and experience in chartering and regulating industrial banks, my view and statement is that industrial banks are the embodiment of what is right and proper in the dual banking system.

The reality is that Utah's chartering and regulating of industrial banks has been commensurate to the risk. Utah, in partnership with the FDIC, has jointly created a supervisory model for industrial banks that has worked for 20 years in that no Utah industrial bank has failed. My belief is that this committee should not consider rewriting banking laws because particular industry groups or trade associations desire to suppress competition. Nor should Congress change, much less outlaw, a proven, successful regulatory structure because some groups have concerns about a particular applicant.

I urge this committee and Congress to focus on the adequacy of the current regulatory process. Without an example of regulatory failure, there is no underlying fundamental reason for public policy change.

Industrial banks are subject to the same laws and regulations and held to the same standards, if not higher standards, than other banks. Supervisory emphasis is placed on Regulation W and Sections 23A and B, which closely regulates all parent and affiliate transactions. Utah takes its supervisory role seriously. It is an active participant with the FDIC in all industrial bank examinations and targeted reviews, wherever they are conducted.

Utah is one of the few States performing CRA compliance examinations. Utah is also participating with the FDIC in the large bank supervision program for four industrial banks. What Utah is engaged in has been called bank-up supervision. The FDIC has more accurately described the regulatory structure as bank-centric. The evolving supervisory processes have fine-tuned the procedures that insulate a bank from potential abuses and conflicts of interest by a parent. Critical controls have been developed.

To me, the separation of banking and commerce is a debatable notion, not a reality. There have always been ways for commercial interests to affiliate with banks and the ability of regulators to prevent potential abuses. Conversely, as the experience of the industry shows, the wall separating banking and commerce is elastic.

The industrial bank experience, like the experience of credit card banks, non-bank banks and other institutions with commercial parents, shows that fears about merging banking and commerce are unfounded. The worst case scenario the detractors have postulated is of a holding company filing bankruptcy or getting into financial difficulty. We have experienced both. While no regulatory relishes stressful circumstances, we can say that we weathered the storm.

In one case, Conseco filed for bankruptcy protection. Conseco Bank's corporate firewalls and the regulatory supervision proved adequate in ensuring the bank's safety and soundness. Thus, the case of Conseco serves as an example of the bank-centric approach working.

In another case, Tyco, the parent of a Utah industrial bank, encountered financial difficulties and decided to spin the industrial bank group off in an IPO which was completed and approved. The Utah Industrial Bank continues operations today.

What has received little attention in the current debate is that industrial bank supervision is supplemented by holding company oversight by other Federal regulators. The SEC and the OTS have oversight over many industrial bank holding companies. As of March 31, 2006, they have 75 percent of Utah's assets under their jurisdiction. If the Federal Reserve's supervision of the parent of two industrial banks are included, the total is 90 percent of Utah assets.

I believe we need to keep in perspective that the entire industrial banking industry, even with the growth during the last 20 years, totals only approximately 1.4 percent of banking assets.

Thank you.

[The prepared statement of Mr. Leary can be found on page 185 of the appendix.]

Mrs. KELLY. Thank you, Mr. Leary.

Mr. Hillman.

**STATEMENT OF RICK HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. HILLMAN. Madam Chairwoman, and members of the subcommittee, I'm pleased to be here today to discuss the results of our 2005 report on Industrial Loan Corporations. My remarks today are primarily based on our 2005 report and focus on the following three objectives: one, the growth and permissible activities of the ILC industry; two, how the FDIC supervisory authority over ILC holding companies and affiliates compares with a consolidated supervisor's authority; and three, the extent to which the ILC charter enables commercial holding companies to mix banking and commerce.

In summary, ILC's began in the early 1900's as small, State-chartered loan companies that primarily served the borrowing needs of industrial workers unable to obtain non-collateralized loans from banks. Since then, the ILC industry has experienced significant asset growth and has evolved into a diverse industry that includes some of the Nation's largest and more complex financial institutions.

For example, from 1987 to March 31, 2006, ILC assets have grown over 3,900 percent, from \$3.8 billion to over \$155 billion. With limited exception, we also found that the ILC's in a holding company structure may generally engage in the same activities as other depository institutions and, as a result, from an operations standpoint, pose risks to the Deposit Insurance Fund similar to other FDIC-insured institutions in a holding company structure.

However, parents of insured depository institutions that present similar risks to the bank insurance fund are not being overseen by bank supervisors that possess similar powers. Under the Bank Holding Company Act, the Board of Governors of the Federal Reserve is responsible for supervising bank holding companies and has established a consolidated supervisory framework for assessing

the risks to the depository institution that could arise because of their affiliation with other entities in the holding company structure.

The Office of Thrift Supervision has similar authority with respect to savings and loan companies. The board and OTS each take a systemic approach to supervising depository institution holding companies and their non-bank subsidiaries and may look across lines of business at operations such as risk management, information technology, or internal audit, in order to determine the risk that these operations may pose to the insured institution.

Because of a provision in the Bank Holding Company Act, a company that owns or controls a federally insured ILC can't conduct banking activities through the ILC without becoming subject to this supervisory regime. Since these ILC's have federally insured deposits, they are subject to supervision by the FDIC as well as their respective State regulators.

However, the FDIC lacks the explicit authority to regulate ILC parent companies and their activities. The FDIC has, however, employed what is termed a bank-centric supervisory approach that primarily focuses on isolating the insured institution for potential risk posed by holding companies and affiliates rather than assessing these potential risks systemically across a consolidated holding company structure.

While the FDIC's cooperative working relationship with State supervisors and ILC holding company organizations combined with its other bank regulatory powers has allowed the FDIC, under certain circumstances, to assess and address the risk to the insured institution, questions remain about the extent to which the FDIC's supervisory approach and authority addresses all risks posed through an ILC from its parent holding company and non-bank affiliates and how well the FDIC's approach would fare for large, troubled ILC's during times of stress.

Another area of potential concern about ILC's is the extent to which they can mix banking and commerce through the holding company structure. The Bank Holding Company Act maintains the historical separation of banking and commerce by generally restricting bank holding companies to banking-related or financial activities.

However, because of the ILC exemption in the Bank Holding Company Act, ILC holding companies, including non-financial institutions such as retailers and manufacturers, are not subject to Federal activity restrictions. Consequently, they have greater latitude to mix banking and commerce than most other financial institutions.

Our report includes matters for Congressional consideration designed to better ensure that insured institutions providing similar risks to the Fund are overseen by bank supervisors that possess similar powers. In this regard, we determined that it would be useful for Congress to consider several options such as eliminating the current Bank Holding Company Act exception for ILC's and their holding companies from consolidated supervision, or granting the FDIC similar examination and enforcement authority as a consolidated supervisor.

In addition, we concluded that it would also be beneficial for Congress to more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether allowing ILC holding companies to engage in this activity more than the holding companies of other types of financial institutions is warranted.

Madam Chairwoman, this concludes my prepared remarks and I'd be pleased to respond to any questions at the appropriate time.

[The prepared statement of Mr. Hillman can be found on page 106 of the appendix.]

Mrs. KELLY. Thank you very much, Mr. Hillman. I'm going to start with the questions and I have just one.

ILC's owned by firms under consolidated supervision by the SEC play an important role in our economy, particularly in facilitating trading and asset management that should not be displaced. I know the member companies of the SIA are committed to good regulation and are willing to work with the committee to ensure this.

I would like to ask the witnesses what regulatory relief steps they would recommend that would allow banks wishing to exchange an ILC charter for a sound traditional State or Federal charter elsewhere to do so without suffering large tax and administrative costs that could harm the economy, and I'm going to throw this open to every member of the Board and start with you, Mr. Alvarez.

Mr. ALVAREZ. Madam Chairwoman, certainly Congress has within its power the ability to confer tax benefits on any organization for transfers. In fact, Congress has done that under the Bank Holding Company Act in several instances where it had required that companies—for example, in 1970 when companies—when the Bank Holding Company Act was amended to allow—to require that companies that owned just one bank would become subject to the Bank Holding Company Act, they required divestiture for many companies that couldn't meet the activities restrictions at the time, Congress granted specific tax benefits to those companies that sold their banks as a result of that requirement. That's something that Congress could certainly do.

Mrs. KELLY. Mr. Jones?

Mr. JONES. I don't know that I could add much to that. I mean, I agree that it's something that if that were to occur, it would have to be done much as the relief that's been done in the past. I think it's within the Congressional prerogative, but I don't know if we have any further suggestions than that.

Mrs. KELLY. Mr. Leary?

Mr. LEARY. I would defer and say that is a Federal tax issue. My point in stressing the OTS SEC supervision was to reinforce the point that there is Federal oversight of the holding companies. Two of the Utah industrial banks have oversight by the Federal Reserve. Our second largest is a financial holding company.

But the fact that there is Federal oversight was my point in stressing that.

Mrs. KELLY. Thank you, Mr. Hillman.

Mr. HILLMAN. It's my understanding that Congress certainly does have the authority with which to make changes to the extent to which institutions would have expenses associated with chang-

ing their charters and in so doing, under a time when we are modifying potentially the ILC charter and its organizations, it would seem appropriate to look at the chartering activities of other institutions.

Mrs. KELLY. Thank you very much, gentlemen. I'm going now to Mr. Ford, I guess.

Mr. FORD. Yes, ma'am. Thank you.

Let me start, if I can, first just by saying thank you and ask one or two questions.

The first, for really anyone on the panel, concerns the GAO report. The GAO report noted that some industry participants asserted that mixing banking and commerce may offer benefits such as increased competition but at the same time empirical evidence documenting this evidence is mixed or may not always be available.

It seems to some of us, or at least to me, that much of this debate focuses on potential issues and not any tangible or existing problems or benefits. I'm interested in knowing kind of in a tangible way what the concrete findings are supporting the pros or cons of allowing these charters and/or ownership, and if any of you feel comfortable or are able to elaborate on some of the empirical evidence mentioned in the GAO report, I'd appreciate it.

Mr. LEARY. I will speak up. From the State's perspective, that's why I emphasized the point that there has been no FDIC-insured industrial bank that has failed in Utah in 20 years of overseeing them. I think it is significant that the GAO report gave scant attention to the fact that there were other options besides Federal Reserve supervision and jurisdiction in that the OTS and the SEC has jurisdictions also over these institutions.

Mr. JONES. I guess if I could—if I understood your question, I think your question was aimed to some extent at whether there has been an advantage so far from the mixing—to the extent there's a mixing of banking and commerce. From our perspective, we haven't seen an advantage at this time, for the institutions that we are supervising as ILC's. They are subject to a number of restrictions which should, if applied properly, limit that, through Sections 23A and 23B of the Federal Reserve Act, the tying restrictions, and many of the other provisions to try to prevent unsafe or unsound actions.

But those, as you said, are focused on today's transactions that we've had.

Mr. FORD. Has there been, to date, any of the certified ILC's that have been dissolved or threatened to dissolve—are we facing any problem with them? Because some of this—the legislation—I'm still trying to decide where I stand on this—just—where is the problem, I mean, because it seems to me that we're looking to fix something that isn't quite broken yet.

So if you'd give me a little sense on what we're fixing here.

Mr. LEARY. From my perspective—

Mr. FORD. Talking about acting—this group here has certainly done an amount of acting. We—yesterday we got on Internet gaming, North Korea fired missiles, so we love acting on things that don't really have a lot to do with what's happening in the world. So I'm just curious; what are we fixing here?

Mr. LEARY. That is my question, also.

Mr. ALVAREZ. Congressman, I think I would respond that we are at a time when we see an exception in the law that is being used in an unintended way and is growing in a very dramatic fashion. Things are no longer the way they were in 1987 when this exception was initially provided.

Now, as I mentioned in my statement, the ILC's which were relatively small in 1987, one of them now is the twelfth largest insured bank in the United States. There's been a dramatic change. We believe that is a reason for Congress to pause and take a look at this exception and make sure that the exception is doing what Congress intended it to do.

It definitely has the potential to undermine the separation of banking and commerce. It is creating a gap in supervision. The holding companies, as you get larger, more complex organizations owning ILC's that are not supervised themselves, that creates a set of risks that we want to make sure Congress is aware of and it's something that we believe Congress should address.

So we're coming to you before missiles are launched with the idea that now is the opportunity to take some action.

Mr. JONES. If I could add to that, Congressman. I mean, I think you raised the issue—the issue is perhaps more the future than the current—

Mr. FORD. Than the present.

Mr. JONES.—we don't—ILC's, in our experience, operate no differently, have no greater risk operationally than any other insured institution. Their problem rates—their failure rates are no different. If we supervise them just like any other bank, I think as noted in the GAO report—they indicated that operationally there is no greater risk—they saw no greater risk in the current ILC's nor any other insured institution.

Mr. FORD. So how big should they get? Because I hear—I tend to—counsel, I tend to—now you're getting somewhere here. I'm trying to figure out what threshold or what—I mean, I take it you all want to have a little more of a regulatory say in this thing. What would be your say?

Mr. ALVAREZ. Well, we think that they're already expanding in a way that now is the time to act, that now is the time to impose the same supervisory regime on owners of ILC's that apply to all the other owners of insured banks, so we have reached that threshold. And we think that the issue of banking and commerce is one Congress needs to grapple with, and that this is the perfect opportunity for that.

Mr. LEARY. May I reinforce the point? If you speak in terms of Merrill Lynch, there is OTS/SEC supervision of the parent company. What you're hearing is that it is not subject to the Federal Reserve.

Mrs. KELLY. Thank you very much, Mr. Ford. Mr. Gillmor.

Mr. GILLMOR. Thank you very much, Madam Chairwoman.

Let me, if I could, go to Mr. Jones. Could you provide additional details regarding the current authority of the FDIC to impose capital requirements on the ILC parent and is that authority different for a new charter versus a change in control?

Mr. JONES. The FDIC doesn't have the authority to impose capital requirements on the parent of an ILC.

Mr. GILLMOR. Okay. Let me ask Mr. Leary of Utah —you made a speech in which you were very laudatory about the GAO and the fact that they were doing a study and said wonderful things. Now that you've seen the results, how do you feel?

Mr. LEARY. I still think they did a very professional job. I disagree with a couple of their conclusions or outcomes. I take comfort from the fact that they said from an operational perspective they are regulated. That's my message.

Mr. GILLMOR. As we know it, an ILC, a non-financial holding company is not regulated in the same way that a holding company of other banks are regulated which creates I think a pretty serious dichotomy. Would you support—so that we have consistency, do you support repealing the Bank Holding Company Act and relieving the other financial institutions of that regulatory obligation?

Mr. LEARY. Let me say that you probably understood that I'm a lifelong regulator. Despite what is here, I'm not a risk-taker. I do not support removing the Bank Holding Company Act, but I believe the exception granted under Federal law is appropriate for the circumstances and we try to regulate to that level, yes.

Mr. GILLMOR. Would you explain to me why it's necessary to regulate the holding company in the other area but because of an ILC that they're somehow so unique that we don't—let me preface that by saying failure of appropriate regulation can have extraordinarily serious consequences. I came to this Congress right after the collapse of the savings and loans and that was a failure of regulation and it cost us about \$300 billion in taxpayer money.

And I felt kind of like the guy who had to clean up after the party that I didn't attend. And, we heard the same statements about how well-regulated these S&Ls were, but in fact they weren't. I guess I'm having a little trouble getting the confidence from you that what you're promoting really works.

Mr. LEARY. Let me preface by saying, number one, I was an examiner at the time of that savings and loan crisis, and the issues. I was one of the people in the field or in a supervisory role dealing with the issues as they collapsed around me.

I have a Naval officer background. I would tell you I would much rather go to sea with an experienced captain than with somebody who is not experienced. I think part of the regulatory structure that we created in Utah, the checks and balances we've created, ensure that those kinds of things will not happen again.

I emphasize that it is an evolving process. As we learn lessons, we constantly add new requirements and new structures into it. Congress has also. They've added a lot of requirements on the banking; all of those requirements added by Congress apply to the industrial banks.

I have a concern with doing away entirely with the bank holding company, which is what I was answering, but I also have a confidence in what we've done, both the State and the FDIC, in ensuring the proper supervision regulation of these institutions from the bank out.

Mr. GILLMOR. I appreciate your comments. I'm still having a little difficulty with having similar situations differently regulated.

I do want to ask Mr. Hillman, in the GAO September 2005 report on the ILC issue, GAO recommends that Congress address the

discrepancies between the Federal Reserve and the FDIC and regulatory authority at the holding company level. Could you tell me if the approach which we're taking or proposing to take in H.R. 5746 is similar to the recommendations of the GAO?

Mr. HILLMAN. The bill that you refer to includes provisions that would provide the FDIC with powers in compelling holding companies to provide reports, to provide powers to the FDIC to examine holding companies and affiliated structures, and it provides powers to the FDIC to enforce those actions similar to the authorities that a consolidated supervisor would have over a holding company structure.

And from that standpoint, Congressman, it is very consistent with a matter for Congressional consideration made in our report that the Congress provide the FDIC with similar consolidated supervisory powers.

Mr. GILLMOR. Thank you very much. I don't know if I've used up my time. If I haven't, I wanted to follow up and ask if you're able to describe the experiences of Japan and Germany in the mixing of banking and commerce. Was that part of some of the issues you considered?

Mr. HILLMAN. That wasn't a specific focus of our work but we have noted that within Europe and within Japan they do allow for a greater mixing of banking and commerce. However, within Europe, they do require consolidated supervision.

Mr. GILLMOR. Which we do not with ILC's.

Mr. HILLMAN. Correct.

Mr. GILLMOR. And as I recall, in Japan, within about a decade or so ago you virtually had a collapse of the banking system that had to be bailed out, which I think makes a point about the regulation that's needed.

Mr. HILLMAN. That's correct. While their regime is different from ours, they had encountered significant problems with non-performing loans which brought their industry to near-collapse.

Mr. GILLMOR. Thank you very much. I yield back.

Mrs. KELLY. Thank you, Mr. Gillmor. Mr. Frank.

Mr. FRANK. Thank you, Madam Chairwoman. I apologize for the back and forth, but we have a bill on the Floor today for this committee on the credit rating agencies, and I was asked to go over there and speak on the rule.

I do want to make clear that there are different levels here. A lot of the argument has been about ILC's. Certainly the approach that the gentleman from Ohio and I have taken is not an anti-ILC bill. In the first place, it does not disrupt any existing entity, and secondly it puts restrictions only on those that are not 85 percent financial.

So that's why when people say, look, the history is that there have been no problems, if history were to remain unchanged this would not be a big issue, but what we have is a large number of new applications. We are about to enter a future, if we don't change things, which will be very different. So the history becomes almost irrelevant.

But let me ask the commissioner from Utah there, and I understand that ILC's play a very constructive role in the State of Utah and if I didn't know that before, having met the gentleman from

Utah, Mr. Matheson, I would know it now. It is a mantra of his, legitimately, because this is important to his State.

What percentage of the assets held by ILC's in Utah would be affected by the 85/15 restriction?

Mr. LEARY. The number is difficult to compute with any accuracy. We have ballparked it that it would be approximately 93 percent of the assets that would be under financial—

Mr. FRANK. So we are talking here about approximately 7 percent of the assets. I understand there's a plus or minus margin of error here. But again, I want to be clear. This is no wholesale assault even on the ILC's in Utah; 93 percent of the assets would not be affected by the legislation we're talking about, although it could be by other legislation involving supervision, although that's not necessarily restrictive.

Next question for the FDIC. Wal-Mart has told us that they're asking for a restricted charter. They're not looking at getting into banking; they say they want to maintain the relationships they have with branch banks in their stores and they're really looking for a more restricted kind of paper processing in their ILC.

Does the FDIC have the legal authority to grant a restricted right to operate? That seems to be a very important question. When Wal-Mart says that this is all it wants to do, that it doesn't want to do these other things, does the FDIC have the authority to grant them only as much as they have asked for, or maybe less than they asked for. Or once you grant it, is it simply a question of what enforcement mechanism would hold them to whatever limitations they were to get if they were to get limitations?

Mr. JONES. I can't speak specifically to the Wal-Mart application but in general—

Mr. FRANK. Yes, in general.

Mr. JONES. In general, we do have—we have the authority to restrict an application when we approve insurance based on prudential considerations or based upon—

Mr. FRANK. Can you restrict it in terms of the activity? In other words, suppose some unknown, unnamed entity said, "Look, all I want to do is process my credit card papers here; I don't plan to take deposits of any kind, and I don't plan to make loans. I just want to be an ILC so I can just do this sort of back office stuff."

Could you give them the right to do that that would in fact contain legally enforceable limits on their going any further?

Mr. JONES. Let me give you a two-part answer. Yes, we could, to the extent that that's all someone asked for, and that's all we considered for deposit insurance; we could limit it. But it is a situation where they could ask on a future date to change it and we'd have to reconsider it if they asked to change it in the future.

Mr. FRANK. Well, what would be the basis for changing it? Would it be like a de novo application or would they gain some leverage from the fact that they already had it there?

Mr. JONES. That would be very fact-specific in any circumstance, but it would—

Mr. FRANK. Okay. So in fact, if they were to ask for something now and get it, you could limit it to what they ask for now but they could come back at any period of time and ask for more.

Mr. JONES. And we would have to evaluate it—

Mr. FRANK. Yes.

Mr. JONES.—risk to the insurance fund and the activity itself.

Mr. FRANK. Let me ask all of our witnesses here—I described the situation. Home Depot is a very good company. If I ever renovated a home, I suppose I'd consider buying stuff from them, but that's not what I do, so I'm not going to ever do that. I mean, I wouldn't want to live in a home that I was in charge of renovating.

But if Home Depot owns the bank, is it a problem if a contractor seeking to maintain the favorable relationship with that bank, which we know exists—if the contractor felt pressured to buy from Home Depot as opposed to its competitors, would that be troubling? Let me ask each of you, starting with the Federal Reserve.

Mr. ALVAREZ. There are two statutory restrictions that your example brings up. One is a Federal anti-tying prohibition, so a bank is not allowed to tie the availability or price of its product—

Mr. FRANK. Right. And it would be bad policy in your judgment.

Mr. ALVAREZ.—and it would be bad policy to do it. And then there's also Sections 23A and 23B which restrict—

Mr. FRANK. Okay.

Mr. ALVAREZ.—transactions—

Mr. FRANK. But I want to—let me just go down the list. Do you think this is something we should try to prevent from happening?

Mr. JONES. Well, I think—as Mr. Alvarez mentioned, I think that has been dealt with at least in part by statute by restricting—

Mr. FRANK. Okay. I understand that. A lot of things have been dealt with by statute but, you know, you heard about the statute of limitations. I'm going to give you a new concept—a limitation of statutes. Just because it's in the statutes doesn't mean that it's going to happen.

So do you think that is something public policy should try to prevent?

Mr. JONES. That's something that we—

Mr. FRANK. Yes or no? It's an opinion—is it something public policy should try to prevent?

Mr. JONES. That is something that we would be concerned about, yes.

Mr. FRANK. Okay. Let me ask, Commissioner, do you think that this is a problem if that were the practice? Do you think we should try to prevent it?

Mr. LEARY. To me? Sorry.

Mr. FRANK. Yes.

Mr. LEARY. The fact and circumstance—I would mirror what the Federal Reserve said. There are two issues—two laws—

Mr. FRANK. No, I'm not asking what the law is.

Mr. LEARY. I understand. My problem in answering that is it's an application in front of me so I don't want to answer it.

Mr. FRANK. All right. Forget Home Depot. Is it a problem in the abstract if a seller of products owns a bank and people doing business with the bank would feel some pressure to then otherwise buy that product? Do you think that's something we should be—

Mr. LEARY. In the abstract, I would say that there are two Federal Reserve regulations in place now that would address that—

Mr. FRANK. Okay. Excuse me. Madam Chairwoman, can I make a new rule: No lawyers to testify. You ask a lawyer his opinion, he

tells you what the law is. You're not in court. I want to know, as public policymakers, what you think public policy ought to be, not what the regulation is. What do you think public policy ought to be in that regard?

Mr. LEARY. I think I have a difficult time answering that without—

Mr. FRANK. Well, that's obvious. Okay.

Mr. LEARY.—conflict on my—

Mr. FRANK. Let me move to the GAO.

Mr. HILLMAN. Congressman Frank, the policy generally separating banking and commerce is based primarily on limiting the potential risk that may result to the financial institution, the deposit insurance fund and—

Mr. FRANK. Okay. I thank you. Go ahead.

Mr. HILLMAN.—and there's three major risks that we're trying to avoid. One of those three risks is what you're referring to, increasing the conflicts of interest associated with having a commercial entity own an insured institution.

Other risks include the potential expansion, as mentioned by the Federal Reserve, of the Federal safety net provided to banks to those commercial entities, and third, an increased economic power potentially being exercised by large conglomerates.

Mr. FRANK. I appreciate that. And there's a second conflict of interest, and that is even more troubling. If I am the potential borrower from the bank owned by Home Depot, and the bank knows that since I've been involved with this contract, if I get the loan I'm going to buy Home Depot's product. It seems to me human nature that the decision on the loan is not going to be made purely on the loan.

And I understand that these are against the law—let me go back to the limitation of statutes—but it is not prudent to give regulators very hard things to enforce. And I think that the practicality of enforcing the anti-tying rules is greatly multiplied when you allow sellers of products unrelated to the financial institution to be in a position where the bank that they own can benefit in two ways, one from the loan, and one from the sale of the product.

Yes, we can make laws against tying but it seems to me wholly imprudent to multiply the opportunities in which regulators who are pretty busy have to read people's minds and try and enforce those laws.

Thank you, Madam Chairwoman.

Mrs. KELLY. Thank you, Mr. Frank.

I'm turning now to Mr. Leach. Mr. Leach has asked for this hearing and has asked the courtesy to be here, so I'm going to call on him. Are you prepared, Mr. Leach?

Mr. LEACH. Thank you very much, Madam Chairwoman. I appreciate your recognizing me.

First, I would like unanimous consent to place a letter of January 20, 2006, from the former Chairman of the Federal Reserve, Alan Greenspan, into the record if I could.

Mrs. KELLY. So moved.

Mr. LEACH. At the end of that letter—and I'd like to turn to Scott for a second—a statement is made, the bill you have introduced, H.R. 3882, would subject the corporate owners of ILC's to the same

prudential framework, including consolidated supervision requirements, bank level capital managerial and CRA criteria enforcement mechanism, and activities limitations, that apply to the financial holding companies under the BHC Act and other Federal banking laws. This approach would address the Board's concerns and ensure a fair and level competitive playing field for all banking organizations.

Now, I understand that this is the Federal Reserve's position today. Is that correct?

Mr. ALVAREZ. Chairman Bernanke has said the same thing, Mr. Leach.

Mr. LEACH. One of the aspects of this that has gotten little attention that, I would like to stress, is that there's an issue of commerce in banking that we all understand. Secondly, there's an issue of competitive equality and regulatory equality for financial companies abroad and at home.

And, for example, as I understand it, Scott, under the current law, a foreign commercial company can apply for an ILC without any oversight of the foreign company's commercial endeavors; it might be the holding company. Is that correct?

Mr. ALVAREZ. That's correct. A foreign company or a foreign bank could. That's correct.

Mr. LEACH. And so what we have under current law, if we don't change it, is an enormous advantage to foreign companies that we may know nothing about obtaining an ILC charter. And this really cries out for thinking through. Secondly, and this is a little bit of a difficulty for this committee to deal with, there are competitive equities here at home.

And so, for example, if a financial company in the United States has an ILC that doesn't come under Federal Reserve supervision, but let's say a commercial bank under the Bank Holding Company Act does, the one has a less comprehensive supervision than another. Is that not true, Scott?

Mr. ALVAREZ. That's true.

Mr. LEACH. And that presents a dilemma because we have this circumstance of seeking the lowest common denominator. And again, I think it's a reason that we ought to think this through.

Let me ask the FDIC representative, does the Federal Deposit Insurance Corporation have a position on the issue of commerce in banking? Do you favor it or do you disfavor it?

Mr. JONES. No, sir, we do not have a position. We view that as a prerogative of Congress.

Mr. LEACH. So you think that's appropriate for Congress to deal with, and you're not intervening in that. And I think that's a correct position of the FDIC. This is a matter for the Congress to deal with. The FDIC argues that it is applying certain standards, and that's absolutely true, to its supervision.

But isn't it also true that you do not have the power of the Federal Reserve by law, as the GAO has pointed out, to look at the holding company structure of ILC's held by commercial companies?

Mr. JONES. We can look at certain aspects as they relate to the bank but we do not have the overall authority to—

Mr. LEACH. And that's what I'm saying. That's a dilemma, too. Now, I have an enormous amount of respect for the FDIC. I am,

however, perplexed that there is no sense of wanting to share accountability and that's one of the reasons that I frankly prefer a little bit our approach to that of Mr. Frank, although Mr. Frank's approach is a very respectable approach, and far better than the current playing field, as far as I'm concerned.

And that is—that relates to shared accountability on how one goes about overall supervision. And here I would like to say to some of the parties, and particularly representatives here from the securities industry, if you take an approach that wants to give comparable authority to the FDIC—and that may or may not occur—vis-a-vis having shared accountability, one of the things you have to ask is what does the FDIC lend to the situation.

And I have long held that one of the anomalies in America is that the Treasury has no treasury in an emergency. The Federal Reserve of the United States has unending pockets under current legal authority without act. And therefore, if I am an investment bank that gets into difficulty, I would sure want to be under Federal Reserve supervision and close to the Federal Reserve, rather than have the Federal Reserve out of the window. And I hope as one looks at differing approaches, the securities industry thinks that through.

But my only strong suggestion here is that if we change the law and move in a direction that tightens up ILC oversight, and it's imperative for Congress to do this, that we do it in such a way that there is a notion of shared accountability, not exclusive accountability, in a way that there is competitive equity in the financial landscape.

Now, the gentleman from Utah is right. There is some other oversight beyond the Federal Reserve that does exist, but it's not exactly the same. And these other oversight agencies are just like the Treasury; they have no treasury.

Mr. PRICE. [presiding] The gentleman's time has expired. Would any of the members of the panel wish to respond or make comment? Mr. Leary?

Mr. LEARY. May I?

Mr. PRICE. You may.

Mr. LEARY. Responding to the Representative's concern, I can think of one foreign bank that is an industrial bank, and that is UBS. It is a financial holding company subject to the Federal Reserve jurisdiction. The only other two foreign entities that own industrial banks directly are Volkswagen and BMW, both of which I understand have significant banking operations in Europe, and are under the consolidated regulatory system in Europe.

Mr. PRICE. I thank the panel. The Chair would remind folks that we have a panel after this one, and that there is another committee hearing at 2:00 p.m., and so we understand everybody's interest in all of this, but we would appreciate it if members would keep their questions brief, and the panel as well.

And Mr. Meeks, you're recognized for 5 minutes.

Mr. MEEKS. Thank you.

I come at this really undecided as to where I'm at on this issue. And my question is somewhat—that I just heard—whether or not there is more of a danger—because I'm trying to figure out where the greatest danger—is there more of a danger in mixing banking

and commerce than it is with the mixing of investment banking with financial management with travel services with credit card companies—you know—because we're in this age where we see things, everybody is trying to do—have the parent company with the subsidiary of that and keep it all in-house.

And I'm trying to see, is there a difference, is there something that I'm missing here that makes a difference in the two?

Mr. ALVAREZ. Congressman, I think that there is a difference between the two, and that Congress has recognized the difference. The motivation behind the Gramm-Leach-Bliley Act where Congress repealed the Glass-Steagall Act, and allowed the affiliation of banks and financial firms, was that there was a lot of substitution going on in the marketplace between the products offered by banks, deposits and investment products, and the kinds of products offered by securities firms and insurance firms.

There's a synergy among those three types of financial institutions and the financial products that they offer. There's always been a conceptual difference between those kinds of financial investment products and manufacturing steel, or selling washing machines, or making cars, which is more the commercial side.

And the history in the United States has been to think carefully before we allow banks to be affiliated with the commercial entities because of the potential for trouble in those commercial entities to bleed into the banks and cause contagion that might cause the failure of the bank, and the potential that the safety net that the bank operates under might benefit the commercial company so that those that own a bank have an advantage over those that don't own a bank, and also for some of the concerns that Congressman Frank was mentioning about the internal conflicts of interest that may occur when a bank is trying to consider whether to offer credit to a customer of its affiliate versus a customer of some other competitor or make a loan to a competitor as opposed to making a loan to the affiliate itself.

So there's a lot of concerns like that that have kept banking and commerce apart so far and those are the kinds of things we think deserve a full debate here in Congress before Congress makes a decision on this. And Congress should make the decision rather than letting an exception in the Bank Holding Company Act determine the future of commerce and banking and take that decision out of the hands of Congress.

Mr. MEEKS. So really, what I'm trying to decipher is the benefits to my constituents and to my community. For example, currently, say GM, who has an ILC, is primarily for their financial company so if I go in and there's zero percent interest if I use their finance company, because that's a subsidiary of the parent company, the benefit comes to the consumer.

Likewise, if there's a large chain—I don't know whether it's Wal-Mart or whether it's Home Depot, etc., if there is a way to bring down the cost to the consumers that would be to their benefit, without creating the dangers that I guess you're talking about as far as the commingling of the funds, etc.—what I'm trying to—why would that be a bad thing?

Mr. ALVAREZ. There's certainly benefits that folks have argued would come about from the mixing of banking and commerce, and

you've referenced a couple. The other side is to consider that the taxpayer also stands behind the Federal safety net that supports the bank and so we want to be able to balance and think through carefully what the cost to the taxpayer would be, as well as the potential benefits that might accrue to customers.

And whether we have the right framework to go forward in banking and commerce is an open question, and that's really what this is, in part, about.

Mr. MEEKS. My last question—and I agree that, you know, Congress should—for example, the FDIC—do you have the power to regulate that now or would it be important for Congress to give you additional power to regulate the parent company of an ILC?

Mr. PRICE. The gentleman's time has expired but you may respond.

Mr. JONES. We do have—at this stage, at least, we believe we have the power to deal with the institutions that are out there that we've experienced to date. We believe the issue from our perspective is really the safety and soundness of the institution and to date, under the existing authority, we've attempted to isolate or insulate the institution from its affiliate or its parent.

We do recognize that it's a very dynamic area, and it's a very changing area, so one of the things we are considering right now and evaluating is whether we need more authority or power. But we think whatever outcome comes out, whether the existing authority or the new authority, ultimately the goal should be to protect the institution and make sure it's protected from the temptations that have been discussed.

Mr. PRICE. Thank you. Mr. Pearce, you're recognized for 5 minutes.

Mr. PEARCE. Thank you. Mr. Leary, if I understand your testimony correctly, it's basically at the end of the day that we're doing it well in Utah and really there's not much cause for alarm. When I look at the situation of long-term capital, which was a hedge fund, it really was in my readings not doing anything against the law; they just began to do a lot of what they were doing and doing it recklessly and many, many institutions then had to pay to bail that situation out.

So you're saying that everything is right now legal, that everybody is running well in the system and you don't see any potential case where a parallel situation, not with a hedge fund but with an ILC, beginning to lend to itself and beginning to really pull in more and more capital could create a problem? You just don't see that?

Mr. LEARY. I would like to say that I'm a regulator, so I worry day and night. I'm a paid professional regulator. But the regulatory structure that is in place has been commensurate to the risk. That is what I have identified. Will there be problems in the future? Undoubtedly. But there's problems across banking into the future. We're getting into new technology, new products, and new services, and each of those have to ferret out what's appropriate.

But I would represent to you that we are comfortable with the level of supervision in place at this point in time. But I clearly want to say that there's always the future, and that's why I stress it is an evolving process; as risks are identified, we'll respond at the State level as rapidly as we can.

Mr. PEARCE. And so in Utah you're not allowing any of the ILC's to fund themselves or lend to themselves or lend to—to form a very close relationship between their customers and themselves?

Mr. LEARY. I would represent only semi-tongue-in-cheek I think we've become Sections 23A and 23B experts at the State level as well as the FDIC, as much as the Federal Reserve, yes. We are very cognizant, very aware of that. That is a supervisory emphasis at every examination where there is a parent.

Mr. PEARCE. Your written testimony indicates that you feel no qualms about the association of commerce and banking, yet when I review the Japanese banking system to where they bought companies, then the companies did two things, invested heavily in real estate, and invested heavily in their own operation; they were funding—loaning to themselves to operate.

Then when the real estate market crashed, it began to put pressure on the banks, the banks crashed, and then the ultimate companies that were involved crashed. And, for me, that's a concern but when I read your testimony and listen to you today you say basically no sweat, no big deal, we've run it okay in Utah.

But I—going back to the long-term capital thing, I've just—I'm sorry—there are events that spin out of control that extend beyond the ability for you to slow them down. The regulators, I suspect, were trying to do something about long-term capital but they just down there sunk the economic ship in the United States, and so when I look at long-term capital and the Japanese market, I'm not so reassured by Utah.

Do you have something that will be the magic potion to reassure me at this point in the day?

Mr. LEARY. What I would give you in a short answer is, I think, the Federal Reserve—we have good confidence in Sections 23A and 23B and the anti-tying provisions which have been identified. I don't know if we have more confidence in the Federal Reserve, but we have confidence in that ability.

We have also taken some prudential—what we call prudential standards. We mandate that all industrial banks have a majority outside unaffiliated directors. We mandate that management is in Utah, so I believe we have a hand on the bank.

What you're asking me, is there some threat in the future that may cause an issue, and I would say as a regulator, I'm a realist and a pragmatist—

Mr. PEARCE. Okay. Let me ask some more questions.

Mr. LEARY.—there may be.

Mr. PEARCE. My time is—have you had any—you say you've had no failures, no bankruptcies of ILC's. Have you had any small community banks just cease to operate, close down?

Mr. LEARY. Yes. I have the unenviable distinction of having the last bank in the county close.

Mr. PEARCE. And that's my concern, again, in my opening statement. Rural areas depend on some source of capital and I will guarantee the rates of return in Hobbs, New Mexico, where I live, will never be what they are in Albuquerque, New Mexico. If we don't have some access to capital, then the economy of the whole United States has to stand on the shoulders of 20 or 30 large com-

munities, or 20 or 30 large banks, and I just don't think it can do it. And at the end of the day, that becomes a very compelling thing.

Thank you, Mr. Chairman, for your time.

Mr. PRICE. The gentleman yields back. Mr. Baca, you're recognized for 5 minutes.

Mr. BACA. Thank you, Mr. Chairman. This question is for Mr. Jones. The U.S. law has historically separated commerce and banking activities to avoid placing Federal deposit insurance fund, which currently amount to \$49 billion, at risk if the banks fail.

Without consolidation supervisory authority over the ILCs' corporate owners, how can FDIC ensure that the ILCs' safety and soundness—which is question number one—and then how can we be sure that a company as large as Wal-Mart won't put our banking systems at risk if it fails and who will it impact most?

Mr. JONES. As I mentioned when we were discussing earlier, our focus is on the safety and soundness of the institution. We have applied the same standards to the institution we do to any other, insulating the institution whether it's an ILC or any bank from its parent and its affiliates to protect them. So we apply the same standards, we had the same focus.

Indeed, with respect to the ILC's, we have a number of them that we—I think at this stage we have 13, because of their size, that we put on what we call the large institution depository program where we evaluate them on a daily basis and at least four of them right now—four at this date we have almost dedicated examiners in there keeping track of them. So we're applying the standards we can under the existing statutory authority we have.

Again, our goal is to try to insulate the bank. Whether in fact there should be a consolidated supervisor is probably—is what this hearing is about and is really—ultimately will be a Congressional concern. We are applying the best standards we can under the statute we have right now.

Mr. BACA. And if we were at risk, who will it impact mostly then, if it fails?

Mr. JONES. Well, if we find—are you talking about the parents at this stage or the bank itself?

Mr. BACA. The bank itself.

Mr. JONES. The bank—the impact unfortunately is going to be the insurance fund, if it fails, will have the greatest impact. That's our goal to prevent the bank from failing to the extent there's been concern on the parent. That's why we try to insulate the bank.

And it was mentioned there have been a couple of instances in the past where a parent of an ILC has gotten in trouble and we have, working with the States, stepped in to insulate the bank, prevent the bank from bailing out the parent, setting the bank up so ultimately it was actually disposed of and sold so it was not harmed by the failure of the parent. And that's our goal when we do the supervision.

Mr. BACA. Okay. Mr. Alvarez, in September of 2005, the GAO advised Congress to consider improving the regulations of the ILCs' banking and holding companies. Do we need to bring existing ILC's and their holding supervision under Federal Reserve supervision, which is question number one? And then two, do you think that the Federal Reserve is better equipped to handle them? And number

three is, how would you recommend that we address the GAO's concerns?

Mr. ALVAREZ. We believe strongly that you should have consolidated supervision since the Federal Government stands behind the Federal safety net. There should be the same regime of supervision over owners of ILC's as there are for the owners of other insured banks.

And that means having a Federal supervisor that has full examination authority, capital authority, authority to have reports, and to bring enforcement actions. Those are the areas that we have under the Bank Holding Company Act and we have a full regime set up under the Federal Bank Holding Company Act and many years of experience in being the umbrella supervisor for owners of insured banks. So we think we're very well equipped to handle the responsibility but we think it's most important that Congress provide a Federal regulator with that authority and the responsibility.

Mr. BACA. Mr. Jones, during its testimony to the FDIC in April, Wal-Mart cited its long-term lease with 1,150 store branches and more than 300 financial institutions as a reason why the company could not easily open branches in its stores. But there's a reason to believe that the statement was inaccurate and that the renewal would also be at Wal-Mart discretion.

What can the FDIC do to prevent Wal-Mart from branching into other States?

Mr. JONES. I have to apologize. It is a pending application, so I can't really discuss it. This almost is a two-part question, I guess, but I can't discuss the actual application. I mean, in the issue of branching, in general we have—we have to approve any branch for any of our banks if it's a State-supervised bank, State non-member bank, so any bank that is supervised by us would ultimately have to have FDIC permission to branch.

Mr. BACA. Okay. Bottom line, if we allow branching into other communities, will the banking industry then be affected if we allow branching out?

Mr. JONES. You're talking in general, not with respect to Wal-Mart? I mean, it's hard to judge at this stage if you had this—

Mr. BACA. I have 30 banks in one place; we allow branching to Wal-Mart or anybody else. Will it impact banking?

Mr. JONES. I don't know if it would impact banking any more than the large banks branching into the communities across the country today. It's going to be a question, you know—it's a competition issue.

Mr. BACA. If you have access to one versus another one, does it impact them—

Mr. PRICE. The gentleman's time has expired.

Mr. BACA. Thank you, Mr. Chairman.

Mr. PRICE. Mr. Hensarling, you're recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

I always try to come to these hearings with an open mind, not—just not an empty mind. And I've come to this hearing with a particularly open mind. Unlike some on this panel, I do not necessarily consider big to be bad, but I do tend to have a bias in thinking that more freedom is good and less freedom may be bad.

And so as I listen to a lot of the testimony, and try to boil it down to—at least a portion of it to its lowest common denominator, I think I hear Mr. Jones saying that we can regulate these ILC's, and Mr. Alvarez saying no, you can't. So Mr. Jones, let me ask you the question.

What is it that in your supervisory powers and structures that you have over the parent companies of ILC's that would be different from the powers and regulatory structure that the Federal Reserve or the OTS would have over parent organizations of insured depositories? What's the difference here?

Mr. JONES. I guess first I'd like to break it down that I think you've raised two issues, whether we can supervise the ILC's and whether we have the same powers as the Federal Reserve does over the parents. I don't think anyone has raised any issues of whether FDIC or the States at this stage can supervise the ILC's. We have the same authorities for those that we have for every insured institution, and I believe even in GAO's report they indicated they found no operational failure on our part for the supervision of the institutions.

The question I think you're really directing is can we oversee or supervise—

Mr. HENSARLING. Well, they have supervisory ability as opposed to authority.

Mr. JONES. Well, supervising a bank, I think we have the same ability to supervise an ILC that we have for any institution. On the parent level, we don't have the same authority as the Federal Reserve. We have some authorities. Largely our authorities apply to insulating the bank from the parent so the parent doesn't pose a risk to it but as has been noted, we cannot apply consolidated capital to the bank. We don't have the same reporting requirements, although we do—we are able to obtain a large number of reporting requirements through both cooperation and in some situations by agreement.

So we don't have the same authorities. We have attempted with the authorities that we do have to make sure we're providing that proper supervision at the bank level.

Mr. HENSARLING. Mr. Alvarez, how does this impact taxpayer exposure and safety and soundness?

Mr. ALVAREZ. Well, Congress has decided that the most effective way to protect the Federal safety net and the taxpayer is to have a two-part supervisory scheme, one that focuses on the depository institution directly, and another that looks at the holding company and its affiliates, and the strength of the holding company and its affiliates.

As Doug mentioned, the FDIC has full authority to look at the bank. That part of the scheme isn't what we question. For owners of ILC's, however, there is no comparable supervision of the holding company itself and its affiliates, so there's exposure to the taxpayer and the safety net through weaknesses that may occur at the holding company. Troubles at the holding company could bleed over into the bank and cause failure at the bank. Capital may be deficient at the holding company and that puts the bank at risk.

So it is—having someone who has the authority to look at, examine, get reports from, and take enforcement actions against the

holding company and its affiliates is the difference between the two.

Mr. HENSARLING. Mr. Hillman, I have not reviewed your study but what are we observing in the real world here? Is there evidence that the FDIC has been less effective in supervising of institutions not owned by bank holding companies?

Mr. HILLMAN. Our work suggests, Congressman, that the work done by the FDIC as it relates to supervising the ILC or the insured institution is similar to the authorities and approaches taken by other Federal regulators in insuring the institution. The question today, however, is the extent to which the FDIC has similar authorities to oversee the holding company structure, the parent organization and affiliate organizations, and in this regard, while the FDIC provides substantial authorities to try to isolate and limit the risks associated with ownership by the parent in a holding company structure to an ILC, it is not equivalent to the authority provided by the Federal Reserve or OTS.

Mr. HENSARLING. In the limited time I have left, I want to replot a little bit of old ground that the ranking minority member brought up and that is it appears that by their testimony, Wal-Mart and Home Depot are looking for a very limited purpose in their ILC charters, and I understand a couple of you gentlemen cannot comment because they are pending.

But I really want to hone in and make sure I understand the answer. Is there an ability to limit the specific purpose that the ILC charter would have? And without commenting, I suppose, on those specific cases, Mr. Jones, could you answer that question yet again so I have a firm understanding of the answer?

Mr. PRICE. The gentleman's time has expired, but you may answer, Mr. Jones.

Mr. JONES. We can—when we approve an application. We can place conditions on the application based upon either items we perceive as risk or items, if we have not made a thorough review, the limitation on what our review was so they're not engaging in other activities. So we can place limitations on an approval that you can—and again, this is in general, but you can place limitations that an institution cannot engage in certain activities either without our consent or without giving prior notice to us so we can take an action on it.

If they do not live up to those conditions, they face severe consequences in the sense of enforcement actions that we can take against them, all the way up to the level of a million-dollar-a-day fine if they're violating a condition. But as I mentioned to Congressman Frank, these are conditions that are imposed at the time based on the facts before us. So to the extent at a later date if they come forward and ask us to re-review it, we have to consider it at that time based upon the facts that exist at that time as well.

Mr. HENSARLING. Thank you.

Mr. PRICE. Thank you, Mr. Jones. Mr. Crowley, you're recognized for 5 minutes.

Mr. CROWLEY. I thank the Chair for recognizing me.

Let me say I, unfortunately, was unable to be here for your testimony, but I have your written testimony, and I will review it. As in my opening statement, I made reference to the fact that what

has made this country great is the level of competition amongst members of particular industries. And I see the same here in the ILC debate, creating opportunities for competition to thrive here in the States and to—it's what's made our country strong.

So I want to just really reiterate my opening statement to a degree, and that is I do support the ILC's in concept, and I don't believe in creating a separate standard for one particular entity to keep one out of the market.

And with that, I will yield the balance of my time to the gentleman from Utah, Mr. Matheson.

Mr. MATHESON. I thank Mr. Crowley for yielding.

I think the line of questioning that Mr. Hensarling just went through really helped crystallize what one of the issues is here that I think we need to acknowledge.

There's nobody arguing that the FDIC and the Federal Reserve have the same ability to look at the holding company, at the parent. I don't think there's anybody who thinks that is the case. The operative question here ought to be under what does the FDIC have its jurisdiction, and the States, does this industry have adequate regulation?

So I want—I think that was very helpful to clarify that, and a lot of people pursued this question. There is no question that the FDIC doesn't have all the authority the Federal Reserve does to look at the holding company, but is only one form of regulation appropriate or are there multiple forms of regulation that may be appropriate? And that is the purpose of this hearing today—to determine if the Industrial Loan Companies, under FDIC and State regulation, are adequately regulated.

In terms of the GAO report, Mr. Hillman, there are a couple of conflicting statements in the report because in the GAO report you first say that, as a number of people mentioned, from an operations standpoint, ILC's do not appear to have a greater risk of failure than other types of depository institutions. But then one of the conclusions—you say ILC's may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company.

How do I reconcile those two statements in your report?

Mr. HILLMAN. Thank you for an opportunity to clarify that.

In our report, we did state and truly believe that from an operational standpoint, ILC's pose no additional risk to the bank insurance fund than do other depository institutions, that the main issues associated with risk to the depository insurance fund have to do with the quality of the institution's business plan or type of activities undertaken, strength of the management and the like. And with an ILC or a bank you're encountering those same types of issues.

We did conclude, however, that from a regulatory standpoint, there were differences in powers between that of the Federal Reserve under a consolidated supervisory regime, and that of the FDIC, to oversee the holding company of the insured institution. So therefore, from a regulatory perspective, we concluded that, yes, ILC's would pose additional risk.

Mr. MATHESON. Did you find any empirical evidence that that's the case, that ILC's have created a greater risk in terms of to the depository insurance fund?

Mr. HILLMAN. Our review focused on the extent to which the Federal Reserve's consolidated supervisory approach and the FDIC's approach to isolate the bank from a potential risk were different, and we found that the FDIC's approach was not equivalent.

Mr. MATHESON. Well, as I said when I started, we all acknowledge they're different, the authority of the FDIC and Federal Reserve. I'm not going to argue about that. And I know at GAO you often are restricted in the scope of your study by the way the request is made and the questions that are asked.

But did you find any evidence that this industry has posed any greater risk in terms of what's happened, particularly in the last 20 years since Steagall was passed in 1987, when this industry has obviously had substantial amount of growth? Is there any evidence that this industry has posed any greater risk to the deposit insurance fund?

Mr. HILLMAN. Certainly since the mid-1990's, I would like to concur with points previously made by prior FDIC Chairman Donald Powell that the banking industry is undergoing a golden age in which the industry is very strong and is thriving. One of our concerns is that the approach that the FDIC follows in its oversight over ILC's and their parents is that this regulatory regime has emerged during a time which has been a golden age in banking—

Mr. MATHESON. I understood that. Let me ask you that. Wouldn't that be true as well for the Federal Reserve's ability to supervise large financial holding companies that were first allowed in 1999 to engage in formally prohibited securities, investment banking, merchant banking, and insurance activities? And since all that experience has also been during these so-called good times, does the GAO think it would be appropriate to question the Federal Reserve's ability to supervise these new entities?

Mr. PRICE. The gentleman's time has expired, but Mr. Hillman, you may respond.

Mr. HILLMAN. Many of the organizations that the Federal Reserve is overseeing, or all of the organizations that the Federal Reserve is overseeing, are entities that operate in a regime that is financial in nature and their oversight over those financial-oriented entities provides them with the necessary expertise and wherewithal to assess, measure, and understand the risks associated with those organizations.

When you're talking about Industrial Loan Corporations, to date, the vast majority of these entities have been financial in nature as well, but when you have an exemption which allows for organizations that are not financial in nature to obtain ownership of depository institutions, then yes, that is a risk that I believe needs consideration.

Mr. MATHESON. I know my time has expired, but that wasn't my question. You didn't answer my question.

Mr. PRICE. Well, you'll be having time to come. Mr. Miller, you're recognized for 5 minutes.

Mr. MILLER OF CALIFORNIA. Thank you very much.

This is something we've been talking about for quite a while. Some have expressed some concern, some have made suggestions that ILC's and holding companies are not adequately regulated and that ownership of ILC's by commercial entities pose some potential risk, you know, based on the relationship between the parent company and the ILC.

And rather than just making assumptions, it would be nice to look at some form of history. And I believe, Mr. Hillman, you'd probably be the most appropriate one to answer this. Have ILC's owned by commercial entities posed safety and soundness problems to a greater or lesser extent than those depository institutions owned by traditional bank holding companies?

Mr. HILLMAN. To date, the number of institutions that are commercial in nature have not been great, nor has their asset base necessarily been great. But for those commercial entities who have owned depository institutions, their default history is similar to those institutions that were owned by financial organizations.

Mr. MILLER OF CALIFORNIA. So there's not a greater or a lesser risk based on everything we see today from one entity to another entity? They're both pretty much the same, as far as risk or history of loss.

Mr. HILLMAN. When you're looking at the past, the number of institutions and the amount of insured deposits are relatively modest. However, when you look into the future now and you look at the extent to which commercial entities have an increasing interest in acquiring an insured institution, the situation may not continue to be the same.

Mr. MILLER OF CALIFORNIA. Do you see, then, a problem with—it seems like if you have more competition, you have more liquidity. And coming from the real estate background I have, it always seems that competition has always been good for the marketplace. My support of GSE's has always been consistent because of liquidity in the marketplace.

Would this not apply in some fashion to this expansion?

Mr. HILLMAN. That clearly is a decision that the Congress needs to decide. The competition within the industry has generally been limited to entities that are financial in nature, except for this exemption with the ILC's.

Mr. MILLER OF CALIFORNIA. Okay. Mr. Jones, I believe, if we talk about a bright line separation between entities of commercial banking and you look at the FDIC oversight, is it adequate to ensure that there's a bright line separation between the entity and—that in some way does not compromise safety and soundness as far as the FDIC is concerned?

Mr. JONES. Could I ask you to ask that question again, please?

Mr. MILLER OF CALIFORNIA. Do you think that current regulations and FDIC oversight are sufficient to ensure a bright line separation between an entity's commercial and banking activities so that there's no compromise of safety and soundness as far as the FDIC is—is there a complete separation that's very clear and identifiable between the commercial entity and the banking activities that they're involved in?

Mr. JONES. As we've discussed, we have attempted to make sure we have an insulation between the bank—and frankly, its parent,

whether it's a financial concern or a non-financial concern—to make sure that the bank is not influenced by its parent in a way that can be adverse to the institution.

We have a lot of safety and soundness provisions and abilities to protect and to try to prevent any influence in the sense of—it's been discussed, 23A and 23B, Federal Reserve, Reg O, the tying provisions, to try to keep the separation. It is an area, though, that we ourselves have recognized that there's a change going on so we're trying to do more of an analysis ourselves to see if there's a change occurring that perhaps does require more powers than we have today.

Mr. MILLER OF CALIFORNIA. So you're taking into consideration that—is there a potential for abuse by a parent company of an ILC and based on current law, are we adequately protected without further regulations being implemented?

Mr. JONES. We always have that in mind no matter who the parent is, whether it's a potential of abuse, and that temptation is always there so we have powers—the same powers we have for all institutions and all their affiliates. It is a bright line and we attempt to enforce it. It's just—it's a question of whether there's a change going on which we haven't seen, at least to date.

Mr. MILLER OF CALIFORNIA. Should Congress decide that this is not what they would deem appropriate to allow whether it be Target or Home Depot or whatever to enter into the sector that we're talking about restricting, how does that impact current companies that are out there working legally within mini states, you know, GMAC, many others out there? How would that affect—would that not literally put them out of business if we changed the Federal law?

Mr. JONES. Well, I guess in part that depends on how you change the law, whether you have a grandfathering-type provision that allows those that currently exist to continue or whether you—

Mr. MILLER OF CALIFORNIA. And that's what raises concern. If there's necessity for grandfathering, why would we be changing it to begin with? If we're allowing something that's currently operating, as Mr. Hillman said, above board and in compliance with the bank holding companies, why would we implement anything that would allow a grandfathering of something that's obviously egregious or questionable or risky?

Mr. PRICE. The gentleman's time has expired, but you may respond.

Mr. JONES. I have to say that sits within the purview of Congress on why you would allow one and not allow the other, so I don't have an answer for you.

Mr. MILLER OF CALIFORNIA. I just wanted to point that out.

Mr. PRICE. Thank you.

Mr. MILLER OF CALIFORNIA. For the record, may I submit testimony of the National Association of Realtors, testimony just for the record?

Mr. PRICE. Without objection.

Mr. MILLER OF CALIFORNIA. Thank you, sir.

Mr. PRICE. Mr. Green, you're recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman, and I also thank the ranking member, and I thank the members of the panel for being here today. I have greatly enjoyed listening to your comments.

We all agree that we don't live in a perfect world. In a perfect world, Enron would still be around. In a perfect world, we wouldn't have had some of the bank failures that we had in the 1980's. And given that we don't live in a perfect world and that people don't have to meet to make decisions that can be adverse to the best interests of others, that things can be done by way of an understanding as opposed to a conspiracy, there is great concern about equality of competitiveness, and I have great concern with reference to conflicts of interest.

Mr. Alvarez, you have indicated that there are laws that—as well Mr. Jones—that can help to thwart—that's my term—some of these concerns. But—and they may have been efficacious and effective with reference to how we were able to work with these bank holding companies, these holding companies for ILC's in the past but as we go into the future with just the size of what we're looking at now, and given the fact that we'll have the commercial side, does this not create a greater amount of concern for you in terms of our ability to make sure that the competitive nature of the holding company the ILC does not prevent good sound business practices in making loans?

Mr. ALVAREZ. Congressman, that's a good question. And the two laws that Doug and I referred to, Sections 23A and 23B, which limits transactions between a bank and its affiliates and then the anti-tying rules are very important to address specific kinds of abuses. But they don't address all the potential concerns that could come up from the affiliation of a bank with another company, and that's the reason that Congress has imposed this dual system of supervision where there's supervision of the holding company as well as supervision of the bank.

I think all of us have testified that ILC's are banks in the same way as any other insured bank. There is no real difference about ILC's so the risks of those organizations are the same. But the system we have for managing those risks is very different and that, I think, is the concern that we want to bring to your attention.

The system of managing those concerns right now involves two-part supervision, and we only have one part of the supervision when it comes to Industrial Loan Companies and the owners of Industrial Loan Companies.

I think the other thing to keep in mind is when you think about competitive equity, the exception is being used now in a way that wasn't originally intended by Congress and threatens to undermine the general approach that applies to all other owners of insured banks.

So there is now a competitive inequality that is developing between the ones that are subject to full supervision at the holding company, all the panoply of supervision at the bank, and restrictions on mixing banking and commerce, and those who operate under the Industrial Loan Company exception which have a much lighter supervisory scheme and no restrictions on their competitive—on their mixing of banking and commerce. That creates an

unbalanced playing field and gives advantages to some that may be things that Congress wants to be concerned about.

Mr. MILLER OF CALIFORNIA. Mr. Jones, do you concur with the premise that the playing field is unbalanced?

Mr. JONES. From the bank perspective, we think if you have the same—it's the same for both. I mean, whether it's an ILC, whether it's a bank, if they're working under the same rules and they're under the same restrictions and prohibitions in the sense of protecting the bank, it's no different than how the bank is operating, and that's our goal to make sure there is no difference.

And I know that there's concern expressed about affiliations with commercial concerns and—or if we're concerned about temptations here. Yes, we are, but we're concerned about temptations from any affiliate and, as you mentioned, we've experienced the same thing in the 1990's from bank holding company affiliate situations, and we hope we've learned lessons from the period in the 1990's, and we hope we learn our lessons as we go forward on issues to try to deal with them.

From the viewpoint of whether it's a banking and commerce issue and whether that's a competitive issue, that's one that we believe is really a Congressional—for Congressional consideration and determination.

Mr. MILLER OF CALIFORNIA. Mr. Alvarez, one more question—

Mr. PRICE. The gentleman's time has expired.

Mr. MILLER OF CALIFORNIA. Well, I thank you, Mr. Chairman.

Mr. PRICE. Chairman Bachus, you're recognized for 5 minutes.

Chairman BACHUS. Thank you.

Mr. Jones, you were asked earlier whether or not you thought the FDIC had enough authority to regulate the ILC's and you said you thought that they did have adequate authority. Is that correct?

Mr. JONES. No, I—we have used the authority we have today and we think it's succeeded based upon the institutions that we have today, and the operations we've seen today, but we have, and we mentioned in our testimony—

Chairman BACHUS. You said you were looking at it.

Mr. JONES.—we're looking, reviewing to see whether we need more, to make sure that the institutions—

Chairman BACHUS. Can you—

Mr. JONES.—are safe and sound.

Chairman BACHUS. You know, could you be a little more specific as opposed to just that you're looking at it? What's the status of the review or—can you be more specific what authority or powers you're looking—

Mr. JONES. We have no specific recommendations at this stage. I guess I have to fall back on the fact that we do have a new chairman who is part of that consideration, and she's only been on board at the FDIC for 2 weeks. So we're working with her. She views this area as a very important area. She's been briefed a number of times in this area but—

Chairman BACHUS. How long has this review been going on?

Mr. JONES. Within some range, it's always going on but it's something which I think there has been more focus on recently as a result of some of the changes that we see going on in the industry.

Chairman BACHUS. When do you think you might be in a position to report to Congress your findings as to whether or not you feel you need more—

Mr. JONES. I can't give you a date on that. I mean, it's something which, once we make the evaluation, if we see the need either for changes within our own structure or needs from legislation, certainly for legislation we'd come to Congress and ask for it.

Chairman BACHUS. But there is an active review ongoing?

Mr. JONES. There is a process of reviewing what's going on; yes.

Chairman BACHUS. Okay. Mr. Leary, some ILC's are subject to the jurisdiction of either the OTS or the SEC.

Mr. LEARY. That is correct.

Chairman BACHUS. What is your working relationship with those agencies and how does it compare with your—the shared supervision you have with the FDIC?

Mr. LEARY. Well, I would tell you since it is a day-to-day relationship with the FDIC, I have used the term repeatedly and continue to believe wholeheartedly it is a partnership with regard to the FDIC. The working relationship is very well developed, well-founded, and I believe we have an ability to communicate on all levels.

With respect to the OTS and SEC, it is not as good simply because we do not work with them as much. I will add that it's probably more a decision on their part. The outreach is there from our part to try and have more of a dialogue, more of a cooperative discussion with those agencies.

Chairman BACHUS. So you would welcome more of the partnership-type relationship that you have with—

Mr. LEARY. Very much so, but I would also tell you we extend that kind of relationship and offer for coordination cooperation with the Federal Reserve. I wish we had a better one there than we do.

Chairman BACHUS. All right. Thank you. Mr. Hillman, Congress has provided, as you know, three models for regulating companies that control insured depository institutions. The Federal Reserve bank holding company model, the OTS savings and loan holding company model, and the FDIC affiliate model all focus, I think, primarily on the depository institution to see that it's at least adequately capitalized, that the parent is able to provide financial support, and that no affiliate can undermine or misuse the depository institution.

And then I think that under all these models, all the agencies have a broad catch-all authority to supplement their express powers, if necessary. Would you comment on whether any agency under those models lacks the necessary powers to be effective regulators, and particularly in the context of ILC's?

Mr. HILLMAN. In our review, one of the major areas that we looked at was the extent to which the consolidated supervisory authorities afforded to the Federal Reserve and the Office of Thrift Supervision were identical to those powers offered by the FDIC and its bank-centric approach to overseeing an insured institution.

And we identified in our report eight authorities that we focused on. For two of those areas there was consistent and equivalent powers across all three organizations in six areas, importantly, dealing with the extent to which an organization can compel re-

ports from the holding company, the extent to which an organization can examine affiliates of a holding company that has no transactions with an entity, and the extent to which an organization can enforce actions on the parent or affiliate transactions, we found that the FDIC's authority was not equivalent to that of the OTS or the Federal Reserve's authority.

Mr. PRICE. The gentleman's time has expired. Mr. Matheson, you're recognized for 5 minutes.

Mr. MATHESON. Thank you, Mr. Chairman.

Mr. Jones, as a representative of the FDIC, who regulates ILC's, I want to get your opinion on a statement that was just made in response to Mr. Green's questioning. Mr. Alvarez, you said that when it comes to ILC's—and I wrote this down so I get it right—there are no restrictions on mixing of banking and commerce.

Mr. Jones, is that true? There are no restrictions on ILC's?

Mr. JONES. From the bank perspective, we feel that it has the same protections that anyone else has, the ones we've discussed with respect to whatever the parent is, that there's restrictions on the activities it can have with the parent or, in the sense of tying, or in the sense of relationship with the parents—

Mr. MATHESON. Thank you. I wanted to make sure we got that on the record.

Mr. Alvarez, you described numerous potential abuses in your testimony that might occur from allowing banks to be affiliated with commercial firms or with financial firms not regulated by the Board. Do you have an answer why, in your opinion, none of these abuses have actually occurred over the past 2 decades?

Mr. ALVAREZ. Well, there has been very little mixing of banking and commerce in the last 50 or 60 years. It is something that is now a recent phenomenon that's happening more through this ILC exception. So it's not surprising that there hasn't been historical failures by this time. We believe that it's time because things have progressed so far for Congress to be aware that this exception is being used in a particular way so that you can deal with the future as it's developing and unfolding.

Mr. MATHESON. Let me ask you, does the Federal Reserve have any opposition to trade associations controlling a bank?

Mr. ALVAREZ. I'm not sure I understand the question.

Mr. MATHESON. The ICBA controls a bank. Do you think that that's appropriate?

Mr. ALVAREZ. The ICBA has a limited purpose credit card bank—

Mr. MATHESON. That's correct.

Mr. ALVAREZ.—that is—that's right, has a limited purpose credit card bank, not a full-service bank, not a bank—

Mr. MATHESON. Okay. Referring to what they do—

Mr. ALVAREZ.—that is an Industrial Loan Company or has the power—

Mr. MATHESON. Understood. I didn't say it was an ILC. Do you have concerns about what it does have?

Mr. ALVAREZ. Well, this is another exception that Congress has created in the Bank Holding Company Act—Congress allows anyone to own a credit card bank if it limits its operations, and we enforce the law as best we can.

Mr. MATHESON. Sure. Let me ask you this. You have concerns about mixing banking and commerce when a commercial entity is owned by a corporation. In light of the fact that many independent banks are owned by business people who own other local businesses, does the Federal Reserve's concern about mixing banking and commerce extend to common individual or family ownership of banks and non-financial commercial businesses?

Mr. ALVAREZ. We haven't had the same concerns about individuals owning both a bank and a commercial entity because we—

Mr. MATHESON. Someone who owns the auto dealership in the town and the community bank in the town, do you have a concern that there could be a mixing of banking and commerce there?

Mr. ALVAREZ. I think there's a rational basis for making a decision that you don't want to restrict individuals from owning where you might want to restrict corporations from owning both banks and commerce because corporations are perpetual entities that have much more access to capital. They can be much larger and the opportunities for mixing their internal activities are much stronger than with individuals.

So we have—again, that's a policy set by Congress that we have followed.

Mr. MATHESON. Okay. Mr. Leary, earlier, one of the members in their opening statement called into question the capabilities of the Utah Department of Financial Institutions to regulate this industry because of smaller staff size and whatnot and I thought you ought to be given an opportunity to respond to that.

Mr. LEARY. Thank you. Of record, we have 37 field examiners; we have authorization to increase that to 42 this year. I think of note in this regard is that the industry supported a fee increase because they wanted to maintain the quality supervision from the Department, including the ILC's, and in fact the largest ILC was the witness supporting the fee increase for the Department.

Being conveyed from the industry, they want us as a strong, well-established regulator. It does them no good, does the State no good if we are not.

Mr. MATHESON. Do you have any—I assume you disagree with some of the criticisms of your supervision of ILC's. Do you have any specific responses to what has been put in the other testimony?

Mr. LEARY. Well, I would limit my comment to a reinforcement of the point, in 20 years there has not been a failure of a Utah industrial bank. I think the Federal Reserve even has concurred that the regulation of the bank has been appropriate commensurate to the risk. Will we always be able to say that? I don't know. I'm a regulator. I live with it day-in and day-out.

My relationship with the FDIC has been such that I think we have performed admirably in that role as a regulator.

Mr. MATHESON. Let me ask one more because my time's about to expire.

A couple of folks have tried to compare circumstances in Japan with what's going on with Industrial Loan Companies. I do not presume that you're an expert on the Japanese banking system, but is that really a fair apples to apples comparison or are we talking about different circumstances?

Mr. LEARY. I think we are talking about different circumstances. I think the Federal Reserve rules in place have provided prudential safeguards. The ones we put in at the State level have provided prudential safeguards that would help ensure the safety and soundness of the bank.

Mr. MATHESON. Thank you. I yield back, Mr. Chairman.

Mr. PRICE. The gentleman yields back the balance of his time. The Chair recognizes Chairman Bachus.

Chairman BACHUS. Thank you, Vice Chairman Price. I appreciate you supervising the hearing and taking over the Chair.

We have votes on the Floor at this time and I think it would be appropriate to dismiss the first panel. I'd ask unanimous consent that the GAO report, if it has not already gone into the record, that it go into the record and—

Mr. PRICE. Without objection.

Chairman BACHUS.—the letter from OTS.

Mr. PRICE. Without objection.

Chairman BACHUS.—and at this time that we recess and at the conclusion of the votes on the Floor we return here and commence the second panel.

Mr. PRICE. Fine. I want to thank the Chair. I want to thank the panel for coming. The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Once again, I want to thank the panel members. We have a couple of votes on the Floor. I would anticipate about 1:15, maybe a few moments before that, for folks' planning purposes.

This hearing stands in recess.

[Recess]

Chairman BACHUS. Good afternoon. We are going to go ahead and get started. We're under a time constraint. Another committee is scheduled to meet in this room at 2:00 p.m., so the good news there is that you probably won't be subjected to intense cross examination, but I'm going to recognize Mr. Matheson to introduce Mr. George Sutton.

Mr. MATHESON. I just very briefly wanted to introduce a constituent of mine from the State of Utah, George Sutton, who is here today representing the SIA group. And Mr. Sutton has a long history in the banking sector. He has in the past worked as a head of financial institutions in Utah. He has worked as a head of two—CEO of two industrial banks and he's currently with the law firm of Callister, Nebeker, and McCullough, and I appreciate him participating today.

Chairman BACHUS. Thank you, Mr. Matheson. I should have introduced the rest of the panel and then come back to you.

Our second panelist, Ms. Terry Jorde, is chairman and president, CEO of the Country Bank in Cando, North Dakota. Of course we've heard of that as Dick Armey's hometown and you said his mother still lives there? Is that right? Or his parents or brother or someone.

Ms. JORDE. Sibling, yes.

Chairman BACHUS. Thank you. And she is representing the—she is actually the chairman of the Independent Community Bankers of America, the ICBA. We welcome you.

Mr. John L. Douglas, partner in Alston & Bird, on behalf of the American Financial Services Association.

Mr. Arthur C. Johnson, chairman and CEO of the United Bank of Michigan, on behalf of the American Banking Association.

Where is the United Bank of Michigan located?

Mr. JOHNSON. In Grand Rapids, Michigan.

Chairman BACHUS. Grand Rapids, Michigan. And we welcome you. And Professor Lawrence J. White, professor of Economics at the Stern School of Business at New York University.

Thank you.

Mr. WHITE. It's located in Manhattan.

Chairman BACHUS. That's fine. NYU.

Mr. WHITE. That's right.

Chairman BACHUS. Thank you. And a fine institution. We welcome your testimony.

And Mr. Michael J. Wilson, director of legislative and political action department at the United Food and Commercial Workers International Union. Welcome to you, Mr. Wilson.

And at this time, we'll start with Mr. Sutton for opening statements.

**STATEMENT OF GEORGE SUTTON, FORMER COMMISSIONER,  
UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS, ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION (SIA)**

Mr. SUTTON. Thank you, Mr. Chairman, and thank you, Congressman Matheson, for the introduction.

Mr. Chairman and members of the subcommittee, I am George Sutton, and I appear today on behalf of the Securities Industry Association. As Congressman Matheson mentioned, I am an attorney practicing in Salt Lake City, Utah, with the firm of Callister, Nebeker, and McCullough. My firm represents many commercial and community banks, two local bank trade associations, and about half of the industrial banks based on Utah, including several of the banks owned by SIA members. At year-end 2005, Utah-based banks owned by securities firms held more than 75 percent of the industrial banks' \$120 billion in assets.

I've been involved in banking regulation for more than 23 years, first as an attorney in the Utah Department of Financial Institutions, and then as the commissioner from 1987 to 1992. Since then, I have been primarily involved in organizing banks and providing other legal services to banks in Utah, which has grown into the ninth largest banking center in the Nation.

I would like to use my limited time today to clarify some of the misinformation that has infected the debate over industrial banks during the past few years. First, there is no safety and soundness issue regarding industrial banks. And I realize that's repetitive but we keep hearing this, and I think it's worth repeating again. The industrial banks in Utah are one of the strongest and safest group of banks that has ever existed.

Second, there is no deficiency in the regulation of the industry. It is equal to, and in some respects stronger than, the regulation

of all other banks. There is extensive and effective regulation of the holding companies and affiliates, and industrial banks' regulators have the authority to examine holding companies and their affiliates, issue cease and desist orders, assess civil money penalties, remove officials, and force divestiture of the bank, if necessary. I have seen these authorities exercised firsthand and they are effective.

In addition, the SEC comprehensively regulates many SIA members and the OTS also regulates Federal savings banks owned by many SIA members. There is no structural risk in allowing banks to be owned by companies that engage in activities other than banking. This is well established within the history of this industry. There is simply no evidence that affiliates engaging in other businesses pose any inherent risk to a bank.

Transactions with affiliates must be carefully monitored for compliance with Sections 23A and 23B of the Federal Reserve Act, and those laws have proven to be workable and effective to ensure that affiliate transactions pose no risk to the bank.

Nor is it the case that a traditional holding company regulation provides better protection for a bank's subsidiary. In reality, most traditional bank holding companies provide little support to their subsidiary banks. I can tell you from a great deal of personal experience during my regulatory days that a traditional holding company provides only minimal support to a bank and is essentially irrelevant if the bank is failing.

In contrast, diversified holding companies often provide a high level of support to a bank. Diversified parents tend to be much larger than the bank and provide extensive financial support, including capital, if problems arise. In some instances, a diversified holding company could easily recapitalize a subsidiary bank if it suffered a total loss of its loan portfolio. Diversified parents also typically provide the bank with an established business so the bank is large and profitable from the outset.

Finally, I would like to briefly discuss the separation of banking and commerce issue. The real public policy underlying that doctrine is credit availability. Separation of banking and commerce began when banks were the primary providers of credit and it was important to maintain separation so all businesses had equal access to credit. But the economy has fundamentally changed during the past 30 years and keeping banking segregated is no longer necessary to assure adequate access to financial services for everyone.

The U.S. economy has become the most prolific and diversified producer of credit that ever existed. Today, companies of every kind increasingly offer financial services. Companies operating outside the traditional bank holding company structure have become major providers of credit and may now provide most of the credit in the economy.

Many of those companies want access to a depository charter because it enables them to provide their financial services more efficiently and cost-effectively. That is what has caused the dramatic growth in the industrial banks over the past 20 years. The real issue in the industrial bank debate is whether the large number of businesses in our Nation that offer bank-quality products and serv-

ices will be allowed to operate in the most efficient and profitable manner.

That concludes my oral presentation, Mr. Chairman. I'd be glad to take questions.

[The prepared statement of Mr. Sutton can be found on page 197 of the appendix.]

Chairman BACHUS. Thank you.

Ms. Jorde.

**STATEMENT OF TERRY JORDE, CHAIRMAN, PRESIDENT/CEO, COUNTRYBANK USA, CANDU, ND, & CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)**

Ms. JORDE. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, my name is Terry Jorde. I'm president and CEO of CountryBank USA in Cando, North Dakota, and I'm also chairman of the Independent Community Bankers of America.

Mr. Chairman, thank you for holding this hearing on a matter of critical importance to our Nation.

The ILC specter looms over our financial system as an ever-increasing number of commercial companies seek to exploit the ILC loophole as a back door entry into banking. This flood of new applications for ILC charters threatens to eliminate the historic separation of banking and commerce and undermine the system of holding company supervision, harming consumers and threatening financial stability.

Both Federal Reserve Chairman Ben Bernanke and former Chairman Alan Greenspan agree that Congress must address this issue. Chairman Bernanke recently wrote, "The question of whether or to what extent the mixing of banking and commerce should be permitted is an important issue and one that we believe should be made by Congress."

In one of his final letters as Chairman, Greenspan wrote, "These are crucial decisions that should be made in the public interest after full deliberation by the Congress. They should not be made through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of States."

Former Senator Garn recently told the FDIC that the ILC charter was grandfathered in 1987 and exempted from the Bank Holding Company Act to serve narrow purposes. Until recently, that is how most ILC holding companies operated. But that is rapidly changing as the Wal-Mart and other applications demonstrate. The narrowly-intended ILC exception could eventually swallow the general rule and a charter based in one State could irreversibly change our financial landscape and our national financial policy without Congress having any say in the matter.

My written statement details the harms that will flow from the exploitation of the ILC loophole and the breach of the separation of banking and commerce. It puts the safety and soundness of the financial system at risk. Problems in a holding company's commercial sector could bleed over into the bank. Just imagine if Enron or WorldCom had owned ILC's.

Wal-Mart's plan to process its payments through its own bank could undermine the integrity of the Nation's payment system and impose great risks. Its stated plan is to process hundreds of billions in payments and is backed by a purely nominal amount of capital.

The Home Depot application presents a clear conflict of interest. The Home Depot Bank will make loans to customers so they can buy products at Home Depot stores. This violates the clear strength of our financial system, the impartial allocation of credit.

The nationwide expansion of ILC's threatens local communities and small businesses. It is unlikely that a bank owned by a major retail company will lend money to its competitors. Deposits would instead be gathered locally but deployed for larger corporate purposes.

Unfortunately, the FDIC currently lacks clear statutory authority to take all these broad policy implications into account as it considers the pending ILC applications. Representative Jim Leach's bill, the Financial Safety and Equity Act of 2005, H.R. 3882, provides the ideal solution. It would require that any company that owns an ILC conform to the Bank Holding Company Act and divest non-financial activities.

ICBA commends Mr. Leach for his leadership. His work was critical in earlier efforts to close the non-bank bank and the unitary thrift holding company loopholes. Without his pioneering work, the separation of banking and commerce would have been long lost and we would likely be dealing with severe problems.

If Congress cannot enact the Leach bill, there is a strong alternative plan drafted by Representatives Paul Gillmor and Barney Frank. Like Mr. Leach, Representatives Gillmor and Frank have worked tirelessly to address the ILC challenge. The new Gillmor/Frank bill, the Industrial Bank Holding Company Act of 2006, would address both elements of the ILC loophole, the separation of banking and commerce, and the need for consolidated supervision of ILC holding companies.

Like much good legislation, the Gillmor/Frank bill includes realistic compromises. It would grandfather existing firms with some restriction, however, it would prevent the FDIC from approving any applications by commercial firms for new ILC's or for acquisitions of existing institutions. The ICBA strongly endorses this bill.

This issue has gone well beyond the interests of a few companies in a handful of States. What Congress grandfathered nearly 20 years ago as a narrow exception threatens to quickly become a way for the Nation's retail and industrial firms to skirt our Nation's financial laws, breach the separation of banking and commerce, and enter into full service banking.

There are 14 applications for ILC charters or acquisitions pending today; more will almost certainly be filed. The financial system's safety and soundness, integrity, and ability to serve local communities and small businesses are all at great risk. Fortunately, Congress has before it strong legislative proposals that will effectively address these risks. ICBA urges Congress to take prompt and positive action before it is too late.

Thank you.

[The prepared statement of Ms. Jorde can be found on page 170 of the appendix.]

Chairman BACHUS. Thank you.  
Mr. Douglas.

**STATEMENT OF JOHN L. DOUGLAS, PARTNER, ALSTON & BIRD,  
LLP, ON BEHALF OF THE AMERICAN FINANCIAL SERVICES  
ASSOCIATION (AFSA)**

Mr. DOUGLAS. Thank you, Mr. Chairman.

My name is John Douglas. I'm a partner in the law firm of Alston & Bird and I am pleased to represent the American Financial Services Association before this panel today. AFSA's members include finance companies, credit card issuers, mortgage lenders, industrial loan banks, and other providers of commercial and consumer credit.

AFSA strongly believes that the industrial bank represents a safe and appropriate means to deliver financial services to the public. They do so in a framework of stringent supervision, strong enforcement, and a structure of laws and regulations that provide the FDIC with all of the tools it may need to address any hypothetical and unproven evils raised by opponents of the charter.

I also come with some personal experience on this issue. I was general counsel of the FDIC during the late 1980's and have a real appreciation for the need for a safe and sound banking system, for strong supervision and clear enforcement powers.

We've heard much of the evils of mixing banking and commerce and the dangers inherent in this unintended loophole being exploited by commercial firms. As I point out in my written remarks, these two propositions are simply historically inaccurate and we should be clear on this point. Affiliations between banking and commercial firms have always existed in this country, and on numerous occasions Congress has addressed and blessed and regulated those affiliations.

But I want to focus my oral remarks on something else we've heard, that the unregulated owners of industrial banks would somehow wreak havoc on our financial system, given the lack of comprehensive supervision. This proposition ignores the existing legal framework governing all financial institutions, including industrial loan banks, and likewise ignores the substantial power and indeed belittles the capacity of the FDIC to supervise, examine, and enforce any laws and regulations designed to assure safety and soundness and prevent abuses.

In testimony before the House Capital Markets Subcommittee, former Federal Reserve Chairman Greenspan once observed, "The case is weak in our judgment for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail." There is no question he was right and I would go even further.

Our comprehensive system of laws and regulations provide ample protection against any risk associated with commercial ownership of industrial banks. I make four points.

First, industrial banks are subject to the same comprehensive framework of laws and regulations that govern normal banks. They have no special power or authority and they're exempt from no statute or regulation.

Second, the FDIC has been given ample authority to supervise and regulate these institutions and can exercise the full range of enforcement powers. I was a participant in the process that led to FIRREA and worked closely with members of this committee and others in Congress with the intention of giving the FDIC all the powers it needed to protect our banking system.

There is no question of its power over industrial banks, over the owners or their affiliates. It has all of the normal cease and desist, removal, and civil money penalty powers, and may take any action it deems appropriate to remedy a violation of law, regulation, rule, or commitment, or an unsafe practice, including even forcing the divestiture of the industrial bank by its owner.

Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers.

Fourth, the experience of the FDIC with respect to industrial loan banks belies any fundamental concern over threats to our banking system. The two failures of industrial banks—FDIC-insured industrial banks owned by holding companies, neither of which, by the way, were commercial enterprises, and neither of which failed as a result of self-dealing or conflicts of interest, stand in sharp contrast to the hundreds of bank failures and holding company structures, many of which cost the FDIC billions of dollars; Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on, all of which were subject to this much-vaunted comprehensive supervision or consolidated supervision by the Federal Reserve as the holding company regulator that is now offered as a cure for something that hasn't proven to be a problem.

Critics assert that the industrial bank would somehow favor its affiliates, discriminate against competitors, or create other unfair advantages. I'd like to point out, however, that if potential discrimination were the issue, banks should not be affiliated with any type of business. Indeed, Bank of America should not be affiliated with Banc of America Securities lest it somehow favor the customers of its securities affiliate to the exclusion of customers of Merrill Lynch.

And if we were really concerned about the potential for abuses and adverse effects, we might more closely evaluate the propriety of small business owners owning controlling interests in banks in small communities where alternative sources of credit are much more limited. Congress has never acted to preclude these affiliations, nor should it, as our existing framework of laws and regulations is more than adequate to prevent abuse.

Finally, if we were really concerned about the potential dangers of mixing banking and commerce, we should roll back the merchant banking powers granted under Gramm-Leach-Bliley, eliminate the FDIC's power to permit commercial activities for banks granted by FDICIA, and maybe even strip commercial lending powers for the few relationships giving a bank a greater interest in or more power over a commercial enterprise than the primary source of its credit.

Our financial system is blessed with competition, innovation, strength, and breadth that is the envy of the world and we should be clear about one aspect of those markets. Throughout our history, there has always been, and Federal law has always blessed, some form of affiliation between banking and commerce.

In our modern era, these relationships have been carefully considered and accompanied by a statutory and regulatory framework designed to prevent abuse and make sure our authorities have substantial power. I think Congress should carefully consider the full implication of any change that could choke off these affiliations, denying our system the flexibility and innovation that's been its hallmark under the guise of advancing concepts with an attractive rhetorical resonance.

Thank you very much.

[The prepared statement of Mr. Douglas can be found on page 94 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Johnson.

**STATEMENT OF ARTHUR C. JOHNSON, CHAIRMAN AND CEO,  
UNITED BANK OF MICHIGAN, ON BEHALF OF THE AMERICAN  
BANKERS ASSOCIATION (ABA)**

Mr. JOHNSON. Mr. Chairman, I'm going to attempt to abbreviate my remarks in the interest of time. I'd like to point out that in addition to my responsibilities as chairman of United Bank in Grand Rapids, Michigan, I'm also the chairman of the American Bankers Association Government Relations Council, and today I'm testifying on behalf of the ABA.

Today I would like to make three points. First, the ILC industry of today bears little resemblance to the ILC industry of 1987 when the current ILC law was enacted. I'll not elaborate on this point too much because much has been said about the history of ILC's, other than to reiterate the point that from 1987 to 2004, the aggregate growth in ILC assets has increased by almost 4,000 percent. A big change.

The second point is that the existing statutory approach is inconsistent with the policy of separating banking from non-financial commerce. The current regulatory approach is inconsistent with the policy of separating banking from non-financial commerce. Congress consistently has acted to close avenues through which non-financial commercial entities could own depository institutions while giving due consideration to the equity of those holding existing investments in such companies.

The ABA consistently has supported and continues to support this policy. We believe Congress should act consistent with its prior efforts to close the ILC loophole. To do otherwise would be to leave open an outdated provision of law that could undermine the legislative steps that you have taken to keep banking and non-financial commerce separate.

And my third point, Congress should act or prohibit future ownership of ILC's by commercial firms. The current statutory landscape, by continuing to permit more non-financial commercial companies to enter the banking field, compounds concerns that conflicts of interest could develop in a more broad-based systemwide way. These policy concerns may have been tolerable when the current ILC exemption was passed and the ILC marketplace was very small. Now, however, with the potential entry of the world's largest retailer, they are not.

The most effective way to ensure that the ILC charter is not misused is to limit ownership of ILC's to companies that are financial in nature. Thus, the ABA recommends that Congress require any company that seeks to establish or acquire an ILC to be a financial firm.

ABA recognizes the legislation affecting ILC's, like previous legislation addressing the banking and commerce issue, will almost certainly grandfather existing owners of ILC's in an effort to strike a balance going forward. However, we urge Congress to bring any grandfathered institution within the jurisdiction of a Federal bank regulator.

I should note that since my written testimony was submitted, Congressmen Paul Gillmor and Barney Frank have introduced H.R. 5746 which prohibits future acquisitions of ILC's by commercial firms, and strengthens the existing regulatory structure. ABA supports H.R. 5746 and will work with the authors and this committee moving forward.

In closing, we believe the time is right for Congress to act on this important issue. I thank you for the opportunity to share the ABA's views and would be happy to answer any questions that you may have either here today or in written form that we could respond to at a later date.

[The prepared statement of Mr. Johnson can be found on page 138 of the appendix.]

Chairman BACHUS. Mr. Johnson, when I introduced you, did I mention that you were representing the ABA? I'm not sure that I did.

Mr. JOHNSON. I'm not sure.

Chairman BACHUS. Okay. I hope that I did. If I didn't, I apologize, but you are representing the American Banking Association.

Mr. JOHNSON. Indeed, I am. Thank you.

Chairman BACHUS. Thank you. Professor White.

**STATEMENT OF PROFESSOR LAWRENCE J. WHITE, PROFESSOR OF ECONOMICS, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY**

Mr. WHITE. Thank you, Mr. Chairman. Thank you for the opportunity to be here today to testify on this important topic.

My name is Lawrence J. White, and I'm a professor of economics at the NYU Stern School of Business. I'm a former board member of the Federal Home Loan Bank Board, but I'm here testifying today on my own. I have not been asked by any organization to testify on its behalf.

In my written testimony, I lay out a principles-based approach for the regulation of banks, really all depository institutions, and of their owners. I'll summarize this statement quickly today. I'm going to have to speak quickly but since I'm a New Yorker, that comes naturally.

My approach basically relies on five principles. First, banks are special. That's why we're here today. Second, because banks are special, they require special regulation—safety and soundness regulation. At the heart of safety and soundness regulation are capital requirements, activities limitations, and management competency

requirements, and all of this is backed up and enforced by a field force of examiners and supervisors.

Third, the restricted activities of a bank should be only those that are examinable and supervisable. By that I mean the activities for which bank regulators can knowledgeably assess risks and set capital requirements and judge managerial competence.

Activities that are not examinable and supervisable should not be allowed for banks, but they should be allowed for the bank's owners, whether that owner is the local car dealer or a large industrial or commercial enterprise, so long as the activity is otherwise legitimate.

Fourth, any person or organization should be allowed to own a bank so long as that entity is financially capable, has a sound business plan for the bank, and is of sound character. Again, this covers the local car dealer as well as large industrial and commercial companies.

Fifth, and perhaps the most important, regardless of who owns the bank, the relationships and transactions between the bank and its owners must be monitored tightly by bank regulators because banks are special, because it is too easy to drain the bank so as to benefit the owners at the expense of the depositors or at the expense of who is backing up the depositors, the deposit's insurer. This is the logic that underlies Sections 23A and 23B of the Federal Reserve Act, and it's a very sensible position.

The application of these principles shows that ILC's are a wholly sensible and worthwhile model for public policy with respect to banks and with respect to who may own them. Indeed, it is a model that should be applied far more widely in the banking sector.

Also, and the topic came up earlier today, there's been lobbying testimony on behalf of the National Association of Realtors on this particular topic. They point out that the logic of the ILC and its owners and the logic of whether banks should be allowed to enter real estate activities such as real estate brokerage are the same. They are correct. It is the same logic, and it should have the same answer.

Banks, depository institutions, should be allowed to be owned by a wide range of organizations along the principles that I've just laid out, and banks should be permitted to enter real estate brokerage.

Thank you for the opportunity to testify, and I'd be happy to answer any questions.

[The prepared statement of Professor White can be found on page 211 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Wilson.

I'm not thanking you for getting into the real estate banking issue.

Mr. WHITE. I couldn't not say it, Mr. Chairman.

Chairman BACHUS. I'm just kidding.

Mr. Wilson.

**STATEMENT OF MICHAEL J. WILSON, DIRECTOR, LEGISLATIVE  
AND POLITICAL ACTION DEPARTMENT, UNITED FOOD AND  
COMMERCIAL WORKERS INTERNATIONAL UNION**

Mr. WILSON. Thank you, Chairman Bachus, and members of the subcommittee, for holding this hearing and for the opportunity to testify. I am here today representing the United Food and Commercial Workers International Union. With 1.4 million members in the United States and Canada, the UFCW represents workers in every State in the United States.

You have my written statement which I submitted earlier this week. I will summarize that, as the last speaker, in order to allow time for questions.

The topic of ILC's and their regulation has been of great concern to the UFCW for several years. The potential mixing of commerce and banking is very troubling. The trend we are seeing today is somewhat reminiscent of an earlier era in American history, an era in which the company town was prevalent.

These company towns were places where workers were dependent on a single company, not just for their jobs but for their housing, for their healthcare, and for their retail needs. Many of the companies that ran these towns developed a track record of unsafe working conditions and abusive dealings with employees on everything from the wages they paid to the amounts they charged for basic staples, to unbelievably high interest rates.

These abuses included practices such as underpaying workers by falsely reporting the amounts those workers produced. What our country learned was that if a company is too powerful and people have to rely on it for too many things, the imbalance of power almost inevitably leads to abuses.

The record push of commercial companies looking to get into the banking industry through ILC exception should remind us all of this lesson. The policy of the United States has long been to explicitly keep banking and commerce separate. That has proven to be sound economic policy and has benefitted consumers who might otherwise find themselves at the mercy of a single large firm for too many of the goods and services they need.

It has also provided for a vibrant and competitive financial services industry that offers many products and services to customers. Our history has included advocacy on the Federal level, on the State level, and internationally, as well. We supported efforts on the Gramm-Leach-Bliley legislation to specifically prohibit the purchase of a thrift in Broken Arrow, Oklahoma, by a large retail concern. Just 2 years later, our Canadian locals joined with us to stop the purchase of Toronto Dominion Bank, which was eventually denied by the Office of Thrift Supervision. And in California, the State Legislature and the Governor enacted legislation closing the ILC loophole in that State.

In 2003, we joined with several other associations to form the Sound Banking Coalition. Wal-Mart, of course, looms large over the present ILC debate. Given its size as the largest corporation in the country, that may be quite appropriate. We are seeing that Wal-Mart is forging a path that many other commercial firms are intending to follow.

There are now a record number of non-financial firms applying to get ILC's, from Blue Cross Blue Shield to Home Depot. This is not, however, a debate about a single company but about Federal policy regarding ILC's and how regulators and Members of Congress can provide security and sound policymaking to our Nation.

We believe that Congress should act. Governors and State legislatures have recognized this and five States—Iowa, Maryland, Vermont, Virginia, and Wisconsin—have already enacted new laws in the last year to restrict ILC's from branching into their States. In fact, just yesterday, Governor Matt Blount of Missouri signed legislation to restrict ILC's from branching into that State.

More States are poised to act and we are engaged in active discussions encouraging States, in the absence of Federal legislative activity, to take appropriate steps. But States should not be forced to take a piecemeal approach to deal with an issue that can be and should be appropriately dealt with at the Federal level.

Representatives Gillmor and Frank have introduced H.R. 5746, the Industrial Bank Holding Company of 2006, to address this problem. We believe that it is a good step in the right direction and that legislation would help address the problems we've discussed regarding ILC's.

In closing, I would say that members of the United Food and Commercial Workers do not want to live in a company town. We seek to live in a Nation of laws and opportunity, and we thank you for your time and for the opportunity to testify.

[The prepared statement of Mr. Wilson can be found on page 223 of the appendix.]

Chairman BACHUS. Thank you, Mr. Wilson. At this time, I'm going to recognize Mr. Gillmor for questions.

Mr. GILLMOR. Thank you very much, Mr. Chairman.

First I'd like to ask unanimous consent—

Chairman BACHUS. One thing. Mr. Gillmor has another hearing so—

Mr. GILLMOR. I just want to thank the gentleman from Iowa and the chairman.

I'd first like to ask unanimous consent to introduce two letters into the record from the American Bankers Association and the American Community Bankers.

Chairman BACHUS. Without objection.

Mr. GILLMOR. First, Mr. Sutton, a question for you. You wrote an article in the Consumer Finance Law Quarterly in which you list some of the primary advantages of an industrial bank such as the ability to avoid penalties when receiving a less than satisfactory CRA rating and the ability to operate under generally less intrusive laws and regulations.

It seems to me kind of a strange argument that you're making in the public interest that we ought to be favoring institutions who don't provide consumer protection and comply with CRA, and those are your words.

Mr. SUTTON. Representative, I do not remember writing those words and, if I did—

Mr. GILLMOR. It was spring of 2002.

Mr. SUTTON.—I completely—

Mr. GILLMOR. Consumer Finance Law Quarterly report. But in any event, that would be an accurate statement, though, wouldn't it, that ILC's could avoid penalties for a less than satisfactory rating more so than banks could who are under the Federal Reserve?

Mr. SUTTON. Well, that's not the case. In fact, all of the industrial banks operating in Utah have either an outstanding or a satisfactory CRA rating and if one of them were to receive a bad rating, they would be subject to all the penalties that would be applicable to any other bank.

And in the industry itself—I mean, I'm confident the industry itself would condemn that.

Mr. GILLMOR. I just quoted you so you probably want to write an addendum or something.

Mr. SUTTON. It was my evil twin.

Mr. GILLMOR. It must have been. Let me go to Mr. Douglas of AFSA. You say you think having strong loaners of depository institutions would diversify sources of income and might be more beneficial to the system. Let me ask you your view on the counter of that.

If you don't have regulation of the holding company, under current law, if they had thought of it at the time, I'm sure that Enron, WorldCom, and Tyco all would have bought an ILC because they would not be subject to regulation at the holding company level.

In view of that, how do you justify not having regulation at the holding company level because the FDIC score in that area is tenuous at best.

Mr. DOUGLAS. Well, a couple of items in response. First, of course, Tyco had an ILC and, notwithstanding the problems of the parent, the regulation—the bank-centric regulation that was present certainly protected that institution.

Second, it wasn't that long ago that we went through the thrift crisis and, frankly, the diversified sources of capital that came into the industry in the 1980's were a blessing and not a curse to that industry. The experience of the FDIC with respect to diversified owners of industrial banks, similar to the experience of the OTS with respect to diversified owners of savings associations would indicate that this is not a problem but in fact a benefit.

Mr. GILLMOR. Let me go to Mr. Johnson at ABA and—well, let me ask you this, before we leave. On the theory that everybody ought to be treated the same, do you feel we should repeal the Bank Holding Company Act so that the same would apply to commercial banks?

Mr. DOUGLAS. I think the bank-centric model of regulation has served us well and obviously it's up to Congress to decide what to do with respect to holding companies and holding company regulations. It's clear that there's an anomaly in the regulatory environment. It is not clear to me that the evidence would support that consolidated supervision is necessarily better for our system.

Mr. GILLMOR. Well, would you explain to me the justification, whether it's better or worse, from your point of view—why you would have one set of financial institutions with a different type and consolidated regulation while you would leave another set of institutions without regulation since, as has been pointed out, there's less consumer protection for those institutions.

Mr. DOUGLAS. Well, I would disagree with the assertion that there's less consumer protection, but one of the benefits of our system is that we've provided a variety of charters and methods for people to deliver financial services in the innovation that's been demonstrated through the industrial bank, similar to the innovation demonstrated through other charters. I think it's been helpful to our economy and not harmful.

Mr. GILLMOR. Let me go to Mr. Johnson of the ABA for one question. There are critics who believe that our bank laws are outdated and perhaps Mr. Douglas is one of them. I'm not sure. When it comes to separating banking and commerce, could you describe for the committee whether you feel it's still relevant to have that separation?

Mr. JOHNSON. Yes. We believe it is still relevant to have that separation. Reference was made earlier in the hearing to the Japanese model, the German model and I am—as a small banker from Grand Rapids, Michigan, am certainly not an expert on that. But what I do know is that the model that we have where the Congress has consistently acted to close exemptions to the division between banking and commerce as those exemptions have caused increased concern, that's a model that has served us very well. And I think that with the strength of our economy that we've had, while operating under that model, has been such that we believe it would be a very dangerous experiment to tinker with it.

Mr. GILLMOR. Thank you very much. And Mr. Chairman, I appreciate the courtesy in recognizing me and Mr. Leach in letting me crowd in line, and I yield back.

Chairman BACHUS. Thank you. Mr. Matheson.

Mr. MATHESON. Thank you, Mr. Chairman. I know you're trying to wrap up this hearing and I'd just ask unanimous consent—

Chairman BACHUS. You have your full 5 minutes.

Mr. MATHESON. If I could just say, could we submit written questions to the witnesses—

Chairman BACHUS. Absolutely.

Mr. MATHESON. Okay. I just wanted to—we've heard reference from one of the—testimony and previous question mentions of Enron and WorldCom and what would have happened if they had an Industrial Loan Company. There are cases in—two situations in Utah, Conseco and Tyco, where the parent company did have financial difficulties.

Mr. Sutton, could you tell everyone what happened with the ILC in those circumstances?

Mr. SUTTON. Well, in the case of Conseco, the regulators were closely monitoring the situation at the holding company. They made sure that the bank was completely isolated from those problems. Eventually when Conseco became bankrupt, the consequence was that the subsidiary bank had to close and be liquidated. But it only held high quality bankable assets. It was able to sell that portfolio at a premium. With those funds, it paid all of its deposit obligations, it paid all of its other debts, and it paid a substantial liquidating dividend up to the parent company that was then distributed out to the bankruptcy creditors.

Mr. MATHESON. So in that case there was no claim on FDIC insurance and the taxpayers are not left to help pay this because the parent company had financial problems.

Mr. SUTTON. Exactly. Now, it might be worth adding that this is a very legitimate concern and it was a concern from the beginning of this industry. I remember when I was regulating I had a discussion with the regional director of the FDIC who said, let's call it the Drexel Burnham test. He said, "I'm not going to grant insurance to any bank that could be owned by Drexel Burnham unless I am convinced that it's safe and it's not going to be a risk to the fund."

And there were some added features to the industrial bank regulatory model created at that time to ensure its independence, to ensure the competence of its management, and to ensure that it was protected from anything like that before this model was ever really allowed to develop.

Mr. MATHESON. So while I guess we can never play the, "what if", game too much, but if those companies had industrial loan banks, at least based on our past history over the last 20 years, when you've had parent companies that have gone into bankruptcy, or at least faced significant financial distress, the bank-centric regulation model has protected that bank asset in a way where there was no claim on FDIC insurance.

Mr. SUTTON. That's the record thus far, yes.

Mr. MATHESON. Okay. I want to make sure that's the case because as I said, Mr. Chairman, in my opening comments, the focus of this hearing is whether or not this industry is adequately regulated. And while we have established that the FDIC has a different role with a bank-centric model compared to the Federal Reserve that does the comprehensive regulation, that doesn't mean one is good and one is bad. And I think that the track record here is one that the ILC industry should be proud of, and the regulatory entities that regulate at both the States and the FDIC should be proud of, because of that track record.

One other reference I want to make. My former senator, Senator Garn, was referenced in one of the testimonies saying that it was a narrow exemption. I would also point out Senator Garn has testified on behalf of the industrial loan industry.

If I could just read four sentences from his participation in the FDIC hearing, and he said, "Congress expressly intended to exempt the parent companies of industrial banks from the Bank Company Holding Act when it enacted CEBA in 1987. That is the law, not a loophole, as some have characterized it. This exemption was debated for several years before it was enacted and Congress has not modified the exemption in any way in the nearly 20 years since it became law. Enacting that exemption has resulted in the development of a major financial services industry whose member banks today are among the safest, strongest and most successful banks in America."

Last question for Mr. Sutton. We've heard some comment—what's that?

Chairman BACHUS. You have a full 5 minutes.

Mr. MATHESON. Okay. Well, he's going to take it—this is a good question, so—one issue I haven't heard a lot of talk about today in

the discussion, but we've heard a lot about, is some comments about industrial banks threatening the payment system.

Can you comment on that issue and the role of industrial banks in that issue?

Mr. SUTTON. You know, we've heard this concern raised and we really struggle to make any sense out of it. The payment system, of course, is the settlement of checks and credit card charges and debit charges and things like that at the end of the day where the banks get together and settle their accounts.

Industrial banks play very little role in this system. There are no industrial banks offering checking accounts. The ones that offer NOW accounts, you know, in total amount to roughly one medium-sized community bank. There are some major credit card issuers but to the largest extent, the other banks do not get into credit card issuance. The ones that do, play by the same rules that everyone else does.

So they really aren't involved in the payment system and we haven't been able to understand how, with that minimal involvement, they can be a threat to it.

Mr. MATHESON. Okay. I'm going to do one more then, Mr. Chairman, since you gave me the full 5 minutes.

Mr. Sutton, we've heard about this massive explosion of this industry over the last 20 years. Is it not true that industrial banks' assets represent between 2 and 3 percent of all bank assets in this country?

Mr. SUTTON. That's my understanding.

Mr. MATHESON. That's right. And how would you describe this growth since 1987? Is this the result of new opportunities in the marketplace or why has this growth happened, even though it's just 2 or 3 percent of the asset base in this country?

Mr. SUTTON. Well, you know, the separation of banking and commerce really is an expression of a more primary policy which is ensuring that everybody has accessibility to credit and that was fashioned when banks were the primary providers of credit.

What has happened in the last 30 years is that financial services have spread through the entire economy. You find businesses of every kind now in the financial services business. And as they get into it, and many of these are as competent as any provider you'll ever find, they know the business well. Many of them invented these businesses to begin with. They're very good at what they do and they figure out after a while that the most efficient way to run the business is to run it through a bank.

And it's these businesses that come to Congress, that come to the regulators and say we're looking for a bank charter and we're willing to run it in a way where we can give good assurance that it's done safely and soundly and that's the record of this industry thus far.

Mr. MATHESON. Okay. Thank you for your patience, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Matheson.

Ms. JORDE. Mr. Chairman, could I just follow up on that question briefly?

The concern that we have, and it's already been brought out before, is not so much the history. It's that the world is changing

very, very rapidly right now and, in fact, that's why we're all here today. The number of applications that we have in place and particularly the Wal-Mart one brought it to everybody's attention.

I mean, Wal-Mart is proposing to capitalize a bank with \$125 million in capital and process \$170 billion in payments each year. That's enormous risk and it's not the type of credit risk that the banking system is used to covering with capital, but it's the ability to be able to settle those payments. \$125 million in capital is very, very little to be able to cover the potential problems that \$170 billion of payments would have going through that system.

Chairman BACHUS. Thank you. Let me conclude this hearing by saying, you know, at the start of this hearing I said that it was not about legislation. It was to look at the Industrial Loan Companies, their structure, their charter, and their regulation.

One reason—and this is a personal opinion of mine, and this is a committee made up of 40-something members, so this is my own personal opinion. There's a lot of unease out there about Industrial Loan Companies, but I'm still not sure that we've defined what the problem is. And legislation is a solution to a problem, but there can't be a solution to the fact that we're concerned about the future.

Is the problem a safety and soundness issue? Mr. Sutton said that the Industrial Loan Companies in Utah—and I've really not seen any evidence to the contrary—I'm not sitting here as a judge, but that they're not among our strongest financial institutions, so I don't know if it's a safety and soundness problem.

I know that people have said, well, the Federal Reserve doesn't regulate the holding companies but in probably 80 or 90 percent of the assets of these Industrial Loan Companies, or the companies themselves, it's my understanding from testimony here today and what I've read before, that the SEC and the OTS have supervisory power over the holding companies. I think Mr. Leary mentioned that in his testimony.

In fact, he said what has received no coverage in the current debate is the fact that industrial bank oversight by the States and the FDIC is supplemented by holding company oversight by financial regulators other than the Federal Reserve. The Securities and Exchange Commission and the Office of Thrift Supervision have regulatory oversight over many holding companies with Utah industrial banks and subsidiaries.

And I think I've heard testimony somewhere that between 75 and 90 percent of the assets and deposits fall into that category. So if we're talking about large security companies owning industrial loan banks, which seems to be the case with 80 or 90 percent of these, then what I'm hearing from the panel that is concerned it's about the commercial firms. It's not 90 percent or 80 percent or 85 percent.

And with the commercial firms, obviously, you know, that is a philosophical—I mean, it's probably economic—philosophical. And I suppose that those who are opposed to that is—what I'm hearing from this panel is at least your concern is focused on those companies.

But then if we get into a grandfather situation, where do you stop? I mean, then, you know—is Congress—is it fair to say that

Target can have one, Wal-Mart can't, and GMAC is right in the middle? So how does Congress—Congress is not very adept at determining fairness in sorting out winners and losers and if any of you would like to comment, we've got about a minute left.

Ms. JORDE. I would comment on that briefly. I have a good friend who made the comment recently that, you know, if the barn door is open and half of the horses run out, what would you do? You'd probably close the barn door and try to keep the rest of them in and then the ones that had gotten loose, try to gain some control over those.

I think we are at a point right now where the barn door has been open and there are a number of horses that are out, but more are right there at the door waiting to get out, and I think the Gillmor/Frank legislation that's been introduced very effectively looks at that issue of grandfathering those institutions that have effectively worked very well as ILC's and it also addresses the commercial companies that are looking to go through that exception and to really mix banking and commerce, which for many, many years this Congress has closed over and over and over again.

So I think the real issue here is the mixing of banking and commerce, the systemic risk created from that, the impartial allocation of credit, and the extension of the Federal safety net to commercial companies. That's the real issue and I think that's why we're here today.

Chairman BACHUS. I'll either let Mr. Douglas or Mr. Sutton have a minute and then we'll conclude the hearing.

Mr. DOUGLAS. In some senses, we're talking—we've spent a lot of time talking about—sorry about that; she didn't want me to talk.

Chairman BACHUS. No, she was helping you; she was moving it towards you.

Mr. DOUGLAS. We've been talking about hypothetical problems that simply don't exist today. Our system really has been blessed by diversified sources of credit, and credit comes through a number of sources, a number of avenues, and in a number of ways. One of those ways recently has been the industrial bank charter.

The fact that the barn door is open is sort of an interesting analogy but it's not relevant to the issue at hand. What we have is a financial system that provides for competition and innovation. There have been no problems with allocation of credit or conflicts of interest or abuses. We have a framework of laws that protects us as a society and our banking system as a system. This is something that we ought to let evolve and proceed and grow and reap the benefits of it.

We have billions of dollars of credit that have been extended to consumers and small businesses by these industrial banks. This is a good thing and not a bad thing.

Chairman BACHUS. Thank you. This will conclude our hearing. I appreciate the testimony of the witnesses today. The Chair notes that some members may have additional questions for the panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses on the record.

This hearing is adjourned.

[Whereupon, at 2:23 p.m., the subcommittee was adjourned.]

# **A P P E N D I X**

July 12, 2006

**STATEMENT OF CHAIRMAN SPENCER BACHUS  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND  
CONSUMER CREDIT  
“ILCS – A REVIEW OF CHARTER, OWNERSHIP AND  
SUPERVISION ISSUES”  
JULY 12, 2006**

Good morning. The subcommittee will come to order. At today’s hearing, which was requested by Mr. Leach, we will examine the charter, ownership, and supervision aspects of Industrial loan corporations, more commonly known as ILCs.

Today, there are 61 ILCs in seven states, with \$155 billion in assets and \$110 billion in deposits. Although the insured deposits of ILCs have grown by over 500 percent since 1999, those deposits represent less than three percent of the FDIC’s total insured deposits. Utah is home to 33 ILCs with approximately \$120 billion in assets; Merrill Lynch Bank is the largest with \$66 billion. California is next, with 15 ILCs and \$17 billion in assets. Most ILCs are owned by financial services firms, such as Citigroup, Morgan Stanley, and American Express. Others, like GE Capital and GMAC Commercial, are within the financial arm of a larger corporate organization. ILCs owned by BMW and Volkswagen support the holding company’s commercial business. Target Corporation, the retailer, has Target National Bank in Utah.

ILCs originated in the early 1900s as small, state-chartered loan companies serving industrial workers, who were unable to borrow from commercial banks. Since then, the ILC industry has experienced significant asset growth and has evolved from small, limited purpose institutions to a diverse industry that includes some of the nation’s largest and more complex

financial institutions. In 1982, Congress made ILCs eligible for Federal Deposit Insurance Corporation (FDIC) insurance, becoming subject to FDIC supervision as well as state regulation. In general, ILCs may engage in the same activities as FDIC-insured depository institutions. ILCs offer a full range of loans, such as consumer, commercial and residential real estate, and small business loans. However, because of restrictions in federal and state laws, ILCs do not accept demand deposits (checking accounts), but do offer NOW (Negotiable Order of Withdrawal) accounts, which give the depository institution the right to require at least seven days notice prior to a withdrawal. Like other depository institutions, ILCs may “export” their home-state’s interest rates to customers living elsewhere and must comply with the Bank Secrecy Act, Community Reinvestment and various consumer protection laws.

Insured ILCs are subject to state banking supervision and FDIC oversight as state banks. Nonetheless, owners of ILCs do not have to be bank holding companies subject to the Federal Reserve’s consolidated supervisory authority. Instead, the FDIC has employed what some call a “bank-centric” supervisory approach that primarily focuses on isolating the insured institution from potential risks posed by holding companies and affiliates, rather than assessing these potential risks systematically across the consolidated holding company structure. In addition, the Securities and Exchange Commission (SEC) oversees financial conglomerates, known as consolidated supervised entities – several of which own one or more large ILCs -- although their main business is in the global securities market. Moreover, in any instance where an ILC and a savings association are affiliated in a corporate structure, the holding company is a savings and loan

holding company subject to regulation by the OTS. Some argue that this regulatory structure for overseeing ILCs may not provide adequate protection against the potential risks that holding companies and non-bank affiliates may pose to an ILC.

Another area of concern about ILCs is the extent to which they can mix banking and commerce through the holding company structure. A special exemption in current banking law permits any type of company, including a commercial firm, to acquire an ILC in a handful of states. For some, this is the crux of the issue. I am sure the separation of banking and commerce will be discussed at length in today's hearing. There is also likely to be a debate over the fairness of excluding some commercial firms from owning or controlling ILCs after other very similar firms are already engaged in the ILC.

Today's hearing will consist on two panels. First we will hear from a distinguished panel of government witnesses including Mr. Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System; Mr. Doug Jones, Acting General Counsel, Federal Deposit Insurance Corporation; Mr. G. Edward Leary, Commissioner for the Utah Department of Financial Institutions; and Mr. Rick Hillman, United States Government Accountability Office.

During the second panel we will hear from witnesses representing the private sector including Mr. George Sutton, former Commissioner for the Utah Department of Financial Institutions, on behalf of Securities Industry Association (SIA); Ms. Terry Jorde, Chairman, Independent Community

Bankers of America (ICBA); Mr. Michael J. Wilson, Director, Legislative and Political Action Department, United Food and Commercial Workers International Union; Mr. Arthur C. Johnson, Chairman and CEO, United Bank of Michigan, on behalf of American Bankers Association (ABA); Mr. John L. Douglas, Partner, Alston Bird, on behalf of American Financial Services Association (AFSA); Mr. Larry White, Professor, NYU School of Business. I look forward to hearing from the witnesses and thank them for taking time from their busy schedules to join us.

In closing, I would like to again thank Mr. Leach. I also want to recognize Ranking Member Frank, Congressman Gillmor and Congressman Royce for all of their efforts and for helping us with today's hearing. They are strongly committed to these issues, and I look forward to working with them and Members of this subcommittee as we examine the ILC charter.

The chair now recognizes the Ranking Member of the Subcommittee, Mr. Sanders, for any opening statement that he would like to make.

**Opening Statement to be Submitted to the Record**  
**Rep. Julia Carson**  
**Financial Institutions and Consumer Credit Subcommittee**  
**ILC Charter, Supervision and Oversight Issues**

Good morning, I would first like to thank the Chairman and Ranking Member for holding this important hearing on industrial loan corporations.

Over the past ten years, the number of large corporations using the ILC loophole to transition into the banking sector has been on a steady incline. The increased use of this loophole is blurring the line between banking and commerce, decreasing competition and deteriorating supervisory authority.

Allowing banking and commerce to merge so close together can be dangerous. If a corporation that is engaged in the retail sector begins to have financial trouble, those troubles can quickly spread the corporation's financial sector. In the past, Congress has actively found ways to supervise and regulate bank holding companies to ensure that a corporation has enough capital to stay financially sound. The ILC loophole has allowed more and more corporations to become FDIC-insured while avoiding restrictions and requirements that other insured financial institutions must adhere to.

Another risk that ILCs pose is to small community banks and local businesses. The twelfth largest insured bank with more than \$54 billion in deposits is an ILC. Some argue that allowing large businesses and corporations to offer

financial products will create competition among banks in a community. However, large corporations are often out for the money and may engage in predatory pricing in order to appeal to customers, and then raise prices once competition is eliminated. This would allow large corporations to create monopolies in small towns in both the retail and financial sectors.

Federal regulators have limited authority to examine bank holding company's business practices and financial soundness. It is important that Congress provide the federal regulators with the tools necessary to examine thoroughly a bank holding company, its subsidiary banks and the relationship between the two. By authorizing this authority, the federal government will be able to protect itself from large scale risks while protecting public interest.

STATEMENT OF THE HONORABLE WM. LACY CLAY  
Before  
The Subcommittee on Financial Institutions  
“ILCs – A Review of Charter, Ownership, and Supervision Issues”  
July 12, 2006

Good morning Chairman Bachus, Ranking Member Kanjorski, Members of the Committee, and Witnesses.

Mr. Chairman, I thank you for holding this hearing. This hearing is necessary in that we have no consistent policy in dealing with ILCs. I have concerns when we have financial institutions that have FDIC insurance, but do not have to submit to oversight by the Federal Reserve. While I find the acquisition and possession of ILCs by financial service firms acceptable, I have reservations about commercial entities owning ILCs. Financial institutions should own financial institutions. Banking and commerce should be left as Gramm, Leach, Bliley originally intended – separate.

We need to be consistent in awarding ILC charters. I, at this time, am not advocating support or nonsupport for either of the companies that I am mentioning. However, I find it disconcerting that Target can be awarded an ILC and Wal Mart cannot. I have read the reasons for this seemingly ambiguous decision and am still not convinced that there is any consistency involved.

We, as a Congressional body, cannot allow loopholes in this legislation. If depository establishment are to exist, they must exist and operate by unambiguously instituted terms. These depository establishments must exist wholly by our policy of keeping separate the arenas of commerce and banking.

I do support the Gilmor – Frank legislation. The bill states specific dates retro-actively negating the legitimacy of ILCs chartered after June 1, 2006. I am in general agreement with the thrust of the bill.

Mr. Chairman, I look forward to hearing the testimony of the witnesses and their responses to the various questions that must and will be asked. I yield back the balance of my time and ask unanimous consent to submit my statement to the record.

## Opening Statement

Congressman Paul E. Gillmor (R-OH)

Subcommittee on Financial Institutions and Consumer Credit

July 12, 2006

*Hearing entitled: "ILCs—A Review of Charter, Ownership, and Supervision Issues"*

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I'd like to thank Chairman Bachus for calling this important hearing today and for his interest in taking steps to address this complicated policy area. We could not be having this oversight hearing at a more critical time. Currently the FDIC has 14 pending ILC applications for deposit insurance, including applications from some of the largest commercial companies in America. All in the past year or so, such diverse commercial firms as Cargill, DaimlerChrysler, Wal-Mart, and Home-Depot have come to the conclusion that they should own and operate a bank.

The problem is that they want different and more lenient rules than other companies that own banks.

There are many important policy questions at work here, but it is my belief that Congress is at a crossroad in financial services regulation. Do we choose to eliminate the historic separation between banking and commerce which has allowed us to avoid the economic pitfalls of Japan and Germany? And if Congress chooses to make that decision, should we make it openly and explicitly rather than simply allowing a loophole in bank law to continue?

Logically you cannot support use of the ILC loophole without repealing the Bank Holding Company Act that applies to other banks. Hardly anyone would support that position due to the dangers it poses to our financial system.

My friend and colleague Barney Frank and I have worked on this issue for several years and know that there is no silver bullet or clean fix. But, we believe there is a sensible approach to begin to answer this question.

Earlier this week, Ranking Member Frank and I introduced a comprehensive ILC reform bill. H.R. 5746 would allow the FDIC to act as a consolidated regulator of ILC parent companies, give the FDIC examination tools similar to the Federal Reserve, limit the business activities of certain commercially-owned ILCs, and most importantly, establish a cut-off date for commercially-owned ILCs so that Congress can evaluate whether or not to explicitly permit the world's largest retailers to operate full-service national banks.

It is my hope that the future of this charter option will be closely examined by my colleagues on this Committee and I look forward to continuing my work with Chairman Oxley, Chairman Bachus, Ranking Member Frank and others to make prudent decisions at this fork in the road.

**Opening Statement**  
**Rep Jim Matheson**  
**Financial Institutions Subcommittee Hearing**  
**“ILCs—A Review of Charter, Ownership, and Supervision Issues”**  
**July 12, 2006**

I would like to thank Chairman Bachus and Ranking Member Sanders for holding this hearing today regarding the industrial loan company or industrial bank (ILC) charter and the framework in which industrial banks are regulated at the state and federal level. It is my hope that this hearing will be a constructive opportunity for the Subcommittee to focus on factual information and legitimate policy issues regarding the regulation of ILCs. I hope that Members will set aside pre-conceived notions and take the time to listen and learn about the supervision of ILCs rather than discussing issues outside the direct scope of this hearing such as bills introduced by ILC opponents or applications for ILC charters not approved or even accepted by the state banking regulator. I hope that Members will come to value the competition and benefits these institutions provide for millions of consumers and businesses around the country every day.

I hope that Members will learn in this hearing what ILCs are and what they are not. Industrial banks are FDIC-insured depository institutions chartered under the laws of Utah, California, Colorado, Nevada, Hawaii, Indiana, and Minnesota. While many critics and competitors of ILCs argue that these institutions are not subject to comprehensive regulation, they are in fact subject to not only regulations and supervision by their respective state banking regulators, but also by the Federal Deposit Insurance Corporation (FDIC), and in many cases, subject to consolidated holding company regulation by the Office of Thrift Supervision (OTS) and the Securities and Exchange Commission (SEC). Industrial banks are subject to all of the federal banking laws that apply to other FDIC-insured state-chartered banks including consumer protection requirements, restrictions on transactions with affiliates, depository reserve requirements, safety and soundness requirements, and Community Reinvestment Act requirements.

Some ILC competitors have argued that these banks pose a threat to the safety and soundness of the national banking system. As a group, industrial banks are better capitalized and better rated than other banks. Former FDIC Chairman Powell asserted that ILC charters “pose no greater safety and soundness risk than other charter types.” And in fact, the much mentioned report issued by the Government Accountability Office (GAO) last year said that “from an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of depository institutions.”

Those who criticize ILCs also argue that these banks allow for the inappropriate mixing of banking and commerce. ILCs cannot engage in any activity not approved by their regulator nor can they engage in any activity not permitted for other insured depository institutions. They are subject to Section 23A and 23B of the Federal Reserve Act which severely restricts transactions between the bank and its parent company. The fact is there no longer is a “bright line” between banking and commerce. The Gramm-Leach-Bliley

Act actually liberalized the ILC charter and authorized commercial banks to engage in a number of formerly prohibited nonbanking/commercial activities including investment banking, merchant banking, insurance underwriting/portfolio investing, and “complementary” activities such as the trading of physical commodities. Many of our nation’s largest commercial banks derive substantial revenues from these once-prohibited activities, and some of these banks have received regulatory approval for real estate development, hotel management, and energy production. The notion that there is a wall separating banking and commerce in our modern and evolving economy is simply not accurate.

Finally, there are those who claim ILCs exist only by virtue of a “loophole.” It is, in fact, the law that allowed the formation of ILCs almost one hundred years ago and it is the law that has allowed the 33 active industrial banks operating in Utah and holding over \$120 billion in assets to do well in a competitive market today. ILC opponents claim that a “loophole” exempts these banks from bank holding company regulation by the Federal Reserve. In fact, Congress expressly exempted the parent companies of industrial banks from the Bank Holding Company Act with the enactment of the Competitive Equality Banking Act in 1987. The exemption was debated before it was enacted and Congress hasn’t modified the exemption since it became law almost twenty years ago.

So, in closing, Mr. Chairman, I would like to thank you again for holding this hearing today. I hope that when the hearing is over, Members will have a better appreciation for the facts surrounding industrial banks including their strong record of effective regulation by the state and federal governments, their history of industry success, and their role in providing greater competition and efficiency to our economy.

For release on delivery  
10:00 a.m. EDT  
July 12, 2006

Statement of  
Scott G. Alvarez  
General Counsel  
Board of Governors of the Federal Reserve System  
before the  
Subcommittee on Financial Institutions and Consumer Credit  
of the  
Committee on Financial Services  
House of Representatives

July 12, 2006

Chairman Bachus, Representative Sanders and members of the subcommittee, I am pleased to testify today on behalf of the Board of Governors of the Federal Reserve System on the topic of industrial loan companies (ILCs). ILCs are state-chartered banks that have direct access to the federal safety net--deposit insurance and the Federal Reserve's discount window and payments system--and have virtually all of the deposit-taking, lending, and other powers of a full-service commercial bank. Despite their access to the federal safety net and broad powers, these banks operate under a special exception to the federal Bank Holding Company Act (BHC Act). This special exception allows any type of firm, including a commercial firm or foreign bank, to acquire and operate an ILC chartered in one of a handful of states outside the framework of federal supervision of the parent holding company and without the restrictions on the scope of activities conducted by the ILC's affiliates that govern the ownership of insured banks by bank holding companies.

The special exception for ILCs has important public-policy implications, which are becoming more acute in light of the remarkable recent growth and potential future expansion of banks operating under the exception. This growth threatens to undermine the decisions that Congress has made concerning the separation of banking and commerce in the American economy and the proper supervisory framework for companies that own a federally insured bank. It also creates an unlevel competitive playing field, allowing some firms to own an insured ILC and avoid the prudential limitations, supervisory framework and restrictions on affiliations that apply to corporate owners of competing insured banks.

If Congress does not address the ILC exception, the nation's policies on banking and commerce and the supervisory framework for corporate owners of insured banks are in danger of being decided *for* Congress through the expansion of this loophole by individual firms acting in

their own self-interest. The Board believes that the decisions on these important policies, which influence the structure and resiliency of our financial system and economy, should be made *by* Congress, acting in the public interest, and then applied to all organizations in a competitively equitable manner.

#### **Prudential Framework Established for Bank Holding Companies**

To understand the issues surrounding ILCs, it may be useful first to review the supervisory and prudential framework that has been established for the parent firms of insured banks generally and the origins of the ILC exception in current law. The federal BHC Act, originally enacted in 1956, created a federal framework for the supervision and regulation of companies that own or control a bank and their affiliates. This framework is intended to help protect the safety and soundness of corporately controlled banks that have access to the federal safety net, ultimately backed by the taxpayer, and to maintain the general separation of banking and commerce in the United States.

Financial trouble in one part of a business organization can spread, and spread rapidly, to other parts of the organization. That is why Congress for many years has required consolidated federal supervision of all bank holding companies, including financial holding companies formed under the Gramm-Leach-Bliley Act of 1999 (GLB Act). It is also why in 1991, following the collapse of the Bank of Credit and Commerce International (BCCI)--a foreign bank that lacked a single supervisor capable of monitoring its global activities--Congress amended the BHC Act to require that foreign banks demonstrate that they are subject to comprehensive supervision on a consolidated basis in their home country before acquiring a bank in the United States. The merits of supervision of the consolidated financial organization--not just the depository

institution itself--also have led many developed countries, including those of the European Union, to adopt this supervisory framework.

Consolidated federal supervision of bank holding companies by the Federal Reserve complements, and is in addition to, the authority that the primary federal or state bank supervisor has over the company's subsidiary depository institutions. It allows a federal supervisor to understand the financial and managerial strength and risks within the consolidated organization as a whole and gives the federal supervisor the ability to address significant management, operational, capital or other deficiencies within the overall organization *before* they pose a danger to the organization's subsidiary insured banks and the federal safety net.

The hallmarks of this consolidated supervisory framework are broad grants of authority to examine and obtain reports from bank holding companies and each of their subsidiaries, establish consolidated capital requirements for bank holding companies, and take supervisory or enforcement actions against bank holding companies and their nonbank subsidiaries to address unsafe or unsound practices or violations of law. Consolidated capital requirements help ensure that bank holding companies have real capital to support their group-wide activities, do not become excessively leveraged, and are able to serve as a source of strength for their subsidiary banks.

Besides requiring consolidated supervision of bank holding companies, the BHC Act also places limits on the types of activities that a bank holding company may conduct, either directly or through a nonbank subsidiary. These activity restrictions, which are designed to maintain the general separation of banking and commerce in the United States, generally allow a bank holding company and its nonbank subsidiaries to engage in only those activities that the Board has determined to be "closely related to banking." Since passage of the GLB Act, a bank holding

company that qualifies and elects to become a financial holding company also may engage in other activities determined by Congress or the Board (in consultation with the Treasury Department) to be financial in nature or incidental to a financial activity, including full-scope securities underwriting and dealing, insurance underwriting and sales, and merchant banking. The GLB Act also permits a financial holding company, to a limited extent, to engage in or affiliate with a company engaged in a nonfinancial activity if the Board determines that the activity is “complementary” to the company’s financial activities and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Importantly, the GLB Act allows a financial holding company to engage in this wider array of financial or complementary activities only if all of the company’s depository institution subsidiaries are--and remain--well capitalized and well managed, and all of its insured depository institution subsidiaries maintain at least a “satisfactory” record of performance under the Community Reinvestment Act (CRA).

#### **The ILC Exception and its Origins**

As I noted earlier, a special exception in current law exempts the corporate owners of ILCs that are chartered in one of a handful of states--principally Utah and California--from the supervisory framework established by the BHC Act. Ironically, this exception for ILCs was enacted in 1987 as part of a broader legislative package designed to *close* an earlier loophole that allowed firms to evade the nonbanking restrictions and consolidated supervisory requirements of the BHC Act. In particular, prior to 1987, the BHC Act defined the term “bank” narrowly to mean an institution that both accepted demand deposits *and* was engaged in the business of making commercial loans. A number of firms--including Sears, Roebuck & Co., Gulf & Western, ITT Transamerica, and Prudential Insurance--took advantage of this narrow definition

to establish so-called nonbank banks, which were FDIC-insured banks that either accepted demand deposits *or* made commercial loans, but did not engage in both activities.

In 1987, Congress enacted the Competitive Equality Banking Act (CEBA) to close the nonbank bank loophole and prevent further evasions of the BHC Act. To do so, CEBA expanded the definition of “bank” in the BHC Act to include any FDIC-insured bank (regardless of the activities it conducts) *and* any banking institution that both offers transaction accounts and makes commercial loans (regardless of whether it is FDIC-insured). Congress enacted this change because of concern that commercial firms were establishing nonbank banks outside of the supervisory framework established by Congress for the corporate owners of insured banks and without regard for the activity restrictions in the BHC Act that were designed to limit the mixing of banking and commerce.

In CEBA, Congress also adopted an exception from this new and expanded definition of “bank” for ILCs chartered in those states that, as of March 5, 1987, had in effect or under legislative consideration a law requiring ILCs to have FDIC insurance. The legislative history of CEBA offers little explanation of why this exception was adopted. This may well be because the size, nature and powers of ILCs were quite limited both historically and in 1987. ILCs were first established in the early 1900s to make small loans to industrial workers. For many years, they were not generally permitted to accept deposits or obtain FDIC insurance. In fact, at the time CEBA was enacted, most ILCs were small, locally owned institutions that had only limited deposit-taking and lending powers under state law. In 1987, the largest ILC had assets of less than \$400 million and the vast majority of ILCs had assets of less than \$50 million. The relevant states also were not actively chartering new ILCs. At the time CEBA was enacted, for example, Utah had only eleven state-chartered ILCs and had a moratorium on the chartering of new ILCs.

Moreover, interstate banking restrictions and technological limitations made it difficult for institutions chartered in a grandfathered state to operate a retail banking business regionally or nationally.

#### **Changing Character and Nature of ILCs**

What was once an exception with limited and local reach, however, has now become the means through which large national and international commercial, retail, and industrial firms may acquire a federally insured bank and gain access to the federal safety net. Indeed, the changes that have occurred with ILCs in recent years have been dramatic and have made ILCs virtually indistinguishable from other commercial banks. For example, in 1997, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves banks, and authorized ILCs to exercise virtually all of the powers of state-chartered commercial banks. In addition, Utah and certain other grandfathered states recently began to charter new ILCs and to promote them as a method for companies to acquire a federally insured bank while avoiding the requirements of the BHC Act.

As a result of these and other changes, the aggregate amount of assets and deposits held by all ILCs operating under this exception increased substantially between 1997 and 2005, with assets increasing nearly 500 percent (from \$25.1 billion to \$150.1 billion) and deposits increasing by more than 800 percent (from \$11.7 billion to \$107.9 billion). The number of Utah-chartered ILCs also has tripled since 1997.

The nature and size of individual ILCs and their parent companies also has changed dramatically in recent years. While the largest ILC in 1987 had assets of less than \$400 million, the largest ILC today has more than \$62 *billion* in assets and more than \$54 *billion* in deposits, making it the twelfth largest insured bank in the United States in terms of deposits. An

additional ten ILCs each control more than \$1 billion in deposits and thus rank within the top 200 insured banks in the United States in terms of deposits. And, far from being locally owned, a number of ILCs today are controlled by large, internationally active commercial companies and are used to support various aspects of these organizations' operations.

While the growth of ILCs in recent years is impressive by itself, it also is important to keep in mind that the exception is open-ended and subject to very few statutory restrictions. Only a handful of states have the ability to charter exempt ILCs. However, there is no limit on the number of exempt ILCs that these states may charter going forward. In fact, several large commercial firms currently have applications pending to establish new ILCs or to acquire existing ones.

Moreover, the BHC Act places only limited restrictions on the types of activities that an ILC operating under the exception may conduct. For example, ILCs may operate under the exception so long as they do not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties. As a substitute, some ILCs offer retail customers negotiable order of withdrawal (NOW) accounts--transaction accounts that are functionally indistinguishable from demand deposit accounts. Small ILCs--those that have assets of less than \$100 million--and ILCs that were chartered before August 10, 1987, and have not experienced a change in control since that date, are not subject to even this limited restriction on their powers. Federal law places no restrictions on the ability of ILCs to collect FDIC-insured savings or time deposits from institutional or retail customers.

Thus, federal law allows a new or existing ILC of any size to offer a wide range of federally insured retail deposit accounts; commercial, mortgage, credit card, and consumer loans; cash management services; trust services; payment-related services, including Fedwire,

automated clearinghouse (ACH) and check-clearing services; and other banking services. Moreover, federal law permits ILCs to branch across state lines to the same extent as other types of insured banks. Importantly, because of advances in telecommunications and information technology, ILCs chartered in one state also now have the ability to conduct their activities throughout the United States, with or without physical branches, through the Internet or through arrangements with affiliated or unaffiliated entities.

#### **Bank Affiliations with Commercial and Financial Firms**

The Board is concerned that the recent and potential future growth of ILCs threatens to undermine the decisions that Congress has made in two important areas. First, the exception is eroding Congress' established policies concerning the mixing of banking and commerce in the United States and diminishing the role of Congress in determining whether or how banking and commerce should be allowed to mix in this country. For many years, Congress has sought to maintain the general separation of banking and commerce and has acted affirmatively to close loopholes that create large breaches in the wall between banking and commerce. For example, one of the primary reasons for enactment of the BHC Act in 1956, and its expansion in 1970 to cover companies that control only a single bank, was to help prevent and restrain combinations of banking and commercial firms under the auspices of a single holding company. And, as noted earlier, when the nonbank bank loophole threatened to undermine the separation of banking and commerce, Congress acted in 1987 to close that loophole.

More recently, Congress reaffirmed its desire to maintain the general separation of banking and commerce in 1999 when it passed the GLB Act. That act closed the unitary-thrift loophole, which previously allowed commercial firms to acquire a federally insured savings association. In addition, after lengthy debate, Congress decided to allow financial holding

companies to engage in only those activities determined to be financial in nature or incidental or complementary to financial activities. In taking this action, Congress rejected proposals that would have allowed financial holding companies to engage generally in a “basket” of commercial activities or that would have allowed commercial firms to acquire a small bank without becoming subject to the BHC Act.

Congress also placed qualifications on the ability of banks to affiliate even with financial firms such as securities firms and insurance companies. The GLB Act allows a financial holding company to affiliate with a full-service securities or insurance firm only if the financial holding company keeps all of its subsidiary depository institutions well capitalized and well managed and all of the company’s subsidiary insured depository institutions maintain at least a satisfactory CRA record.

The ILC exception undermines each of these decisions by allowing commercial and financial firms to operate FDIC-insured ILCs while avoiding the restrictions on commercial affiliations applicable to the corporate owners of other insured banks and avoiding the capital, managerial, and CRA requirements applicable to financial holding companies.

The question of whether to allow broader mixings of banking and commerce has broad-reaching implications for the structure and soundness of the American economy and financial system particularly because, if permitted, any general mixing of banking and commerce is likely to be difficult to disentangle. Consequently, the nation’s policy on this important issue should be set by Congress only after deliberate and careful consideration; it should not be allowed to occur unintentionally through the exploitation of an exception by individual commercial firms.

**Importance of Consolidated Supervision**

Second, the ILC exception undermines the supervisory framework that Congress has established for the corporate owners of insured banks. On this point, let me be clear that the Board has no concerns about the adequacy of the existing supervisory framework for ILCs themselves. ILCs are regulated and supervised by the FDIC and their chartering state in the same manner as other types of state-chartered, nonmember insured banks.

However, due to the special exception in current law, the parent company of an ILC is not considered a bank holding company and is not subject to federal supervision on a consolidated basis under the BHC Act. This creates a supervisory blind spot because the Federal Reserve's supervisory authority over bank holding companies and their nonbank subsidiaries under the BHC Act is significantly broader than the supervisory authority that the primary federal supervisor of an ILC has over the holding company and nonbank affiliates of the bank. It was precisely to avoid the risks of this blind spot that Congress established a supervisory framework for bank holding companies and savings and loan holding companies that includes a federal supervisor of the parent holding company and its nonbank subsidiaries as well as a federal supervisor for the insured depository institution itself.

For example, the BHC Act provides broad authority to examine a bank holding company and its nonbank subsidiaries, whether or not the company or nonbank subsidiary engages in transactions, or has relationships, with a depository institution subsidiary.<sup>1</sup> This authority

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<sup>1</sup> In the case of certain functionally regulated subsidiaries of bank holding companies, the BHC Act directs the Board to rely to the fullest extent possible on examinations of the subsidiary conducted by the functional regulator for the subsidiary, and requires the Board to make certain findings before conducting an independent examination of the functionally regulated subsidiary. 12 U.S.C. §1844(c)(2)(B). These limitations also apply to the FDIC and other federal banking agencies in the exercise of their more limited examination authority over the nonbank affiliates of an insured bank, such as an ILC. See 12 U.S.C. § 1831v.

supplements and complements the authority of the primary bank supervisor. Pursuant to this authority, the Federal Reserve routinely conducts examinations of all large, complex bank holding companies and maintains inspection teams on-site at the largest bank holding companies on an on-going basis. These examinations allow the Federal Reserve to review the organization's systems for identifying and managing risk across the organization and its various legal entities and to evaluate the overall financial strength of the organization. By contrast, the primary federal supervisor of a bank, including an ILC, is authorized to examine the parent company and affiliates (other than subsidiaries) of the bank only to the extent necessary to disclose the relationship between the bank and the parent or affiliate and the effect of the relationship on the bank.

Federal law also grants the Federal Reserve the authority to require that bank holding companies maintain adequate capital on a consolidated basis to help ensure that the parent company is able to serve as a source of strength, not weakness, for its subsidiary insured banks. The parent companies of exempt ILCs, however, are not subject to the consolidated capital requirements established for bank holding companies. Indeed, among the factors contributing to the failure of a federally insured ILC in 1999 were the unregulated borrowing and weakened capital position of the corporate owner of the ILC and the inability of any federal supervisor to ensure that the parent holding company remained financially strong.

In addition, federal law gives the Federal Reserve broad enforcement authority over bank holding companies and their nonbank subsidiaries. This authority includes the ability to stop or prevent a bank holding company or nonbank subsidiary from engaging in an unsafe or unsound practice in connection with its own business operations, even if those operations are not directly connected with the company's subsidiary banks. On the other hand, the primary federal bank

supervisor for an ILC may take enforcement action against the parent company or a nonbank affiliate of an ILC to address an unsafe or unsound practice only if the practice occurs in the conduct of the *ILC's* business. Thus, unsafe and unsound practices that weaken the parent firm of an ILC, such as significant reductions in its capital, increases in its debt or its conduct of risky nonbanking activities, are generally beyond the scope of the enforcement authority of the ILC's primary federal bank supervisor.

Consolidated supervisory authority is especially helpful in understanding and, if appropriate, controlling the risks to the federal safety net when a subsidiary bank is closely integrated with, or heavily reliant on, its parent organization. In these situations, the subsidiary bank may have no business independent of the bank's affiliates, and the bank's loans and deposits may be derived or solicited largely through or from affiliates. In addition, the subsidiary bank may be substantially or entirely dependent on the parent or its affiliates for critical services, such as computer support, treasury operations, accounting, personnel, management, and even premises. This appears to be the case at some of the largest ILCs. In fact, seven of the ten largest ILCs each have more than \$3 billion in assets but fewer than 75 full-time employees.

In addition to constructing this supervisory framework domestically, Congress has made this type of consolidated supervisory framework a prerequisite for foreign banks seeking to acquire a bank in the United States. In 1991, Congress amended the BHC Act to require a foreign bank to demonstrate that the consolidated organization is subject to comprehensive supervision in its home country before acquiring a U.S. bank or establishing a branch, agency or commercial lending company subsidiary in the United States. Adoption of a framework of consolidated supervision of banking organizations is, in fact, becoming the preferred approach to

supervision worldwide. The ILC exception, however, allows a foreign bank that is not subject to consolidated supervision in its home country to evade this requirement and acquire an FDIC-insured bank with broad deposit-taking and lending powers in the United States.

**Fair Competition and Other Issues**

In considering these issues, it is important that Congress establish a fair and level competitive playing field for firms that seek to own a bank with full access to the federal safety net and carefully consider the potential interplay of its decisions on the multitude of issues associated with ILCs. For example, if Congress determines that broader mixings of banking and commerce should be permitted, that new policy should apply to all banking organizations in a competitively equitable matter. In addition, Congress should carefully consider the type of supervisory framework that best suits the needs and structure of our financial system and protects insured banks and the taxpayer.

**Conclusion**

The issues I have discussed today involve important public-policy matters and the Board applauds the subcommittee for holding this hearing to obtain testimony on these issues. In particular, I appreciate the opportunity to discuss the Board's views on ILCs. The Board and its staff would be pleased to work with the subcommittee, the full committee, and their staffs in addressing the important issues raised by the ILC exception in current law.

**HOUSE COMMITTEE ON FINANCIAL SERVICES**

Subcommittee on Financial Institutions and Consumer Credit  
ILCs -- A Review of Charter, Ownership, and Supervision Issues

Wednesday, July 12, 2006

**WRITTEN TESTIMONY OF JOHN L. DOUGLAS  
ON BEHALF OF  
THE AMERICAN FINANCIAL SERVICES ASSOCIATION**

HOUSE COMMITTEE ON FINANCIAL SERVICES  
Subcommittee on Financial Institutions and Consumer Credit  
ILCs -- A Review of Charter, Ownership, and Supervision Issues  
Wednesday, July 12, 2006

WRITTEN TESTIMONY OF JOHN L. DOUGLAS

Good morning. My name is John Douglas, and I am a partner in the law firm of Alston & Bird. I am pleased to represent the American Financial Services Association (“AFSA”) before this panel. AFSA is the national trade association for the consumer credit and finance industry. It represents the nation’s market rate lenders providing access to credit for millions of Americans. AFSA’s 300 member companies include consumer and commercial finance companies, “captive” auto finance companies, credit card issuers, mortgage lenders, industrial loan banks, and other financial service firms that lend to consumers and small businesses.

AFSA strongly believes that the industrial bank option represents a safe, sound and appropriate means to deliver financial services to the public. Congress appropriately established a strict legal framework within which commercial companies, such as those that are members of AFSA, can provide deposit, loan and other banking products. This framework is highlighted by stringent and appropriate supervision, by strong enforcement powers and by a structure of laws and regulations that provides the FDIC with all the tools it may need to address any hypothetical – and unproven – evils raised by the opponents of the industrial bank charter.

I also come with personal background and experience on this issue, having served as General Counsel of the Federal Deposit Insurance Corporation from 1987 through 1989, a period of tremendous stress in our financial system, where we witnessed the massive bank and thrift failures of the late 1980’s, the insolvency of the Federal Savings

and Loan Insurance Corporation, the creation of the Resolution Trust Corporation and the appropriation of billions of taxpayer dollars by Congress to resolve the crisis. In recent years, I have also provided advice to banking regulators in Russia, Egypt, and Indonesia, and I know, first-hand, the range of problems that flow from lax supervision and inadequate enforcement. I have a healthy respect for the need for a safe and sound financial system. Both before and since my service as the FDIC's General Counsel, my legal practice has been devoted to the representation of a number of banking and non-banking entities engaged in the financial services business.

In the past several months, there has been great public angst concerning the industrial loan bank issue. To be fair, it is part of a broader debate concerning bank ownership that has gone on at least since the Glass-Steagall Act in 1933<sup>1</sup> and, we thought, was settled with the passage of the Gramm-Leach-Bliley Act of 1999.<sup>2</sup> Fundamentally, the concerns of policymakers should be centered on the proper activities of a bank that will accept funds from the public in the form of deposits. Regrettably, it seems to have instead evolved into a debate over who can own a bank, and, worse, it seems to have devolved into a process of presenting innuendo and half-truths that do little to inform the issue and arguably conceal motives designed to eliminate or curb potential competition in the delivery of important financial services to the public.

In listening to one side of this debate, one might conclude that some great evil will result from mixing banking and commerce were commercial companies allowed to own industrial loan banks; and that Congress unintentionally left a "loophole" that may be exploited by commercial companies that will somehow endanger our economy. These first two assertions are simply historically inaccurate,<sup>3</sup> and ignore the fact that throughout

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<sup>1</sup> The Glass-Steagall Act separated to a limited degree investment and commercial banking. The separation was never absolute; indeed, it was substantially eroded by regulatory interpretations by the Federal Reserve in the 1980's and 1990's. Whatever separation remained was essentially eviscerated by the adoption of the Gramm-Leach-Bliley Act in 1999.

<sup>2</sup> Pub. L. 106-102, 113 Stat. 1338 (1999).

<sup>3</sup> I will not repeat the arguments that have been presented before Congress many times in the past on the first two assertions. As to the "historic" separation of banking and commerce, I will merely note that it wasn't until 1956 that activity restrictions were placed on multi-bank holding companies and that those restrictions weren't extended to single bank holding companies until 1970. Further, it wasn't until 1999 that activity restrictions were imposed on unitary savings and loan holding companies. As for the

our history there have long been affiliations between banks and commercial firms. Indeed, many of these affiliations have been expressly blessed by Congress. We should be clear on this point. Such affiliations have always existed. Congress has chosen to limit certain of them from time to time, but the Bank Holding Company Act,<sup>4</sup> the Competitive Equality Banking Act,<sup>5</sup> the Federal Deposit Insurance Corporation Improvement Act<sup>6</sup> and the Gramm-Leach-Bliley Act<sup>7</sup> each address, and bless, and regulate, commercial affiliations with banks.

Another assertion that has recently been made is that the unregulated owners of industrial banks would wreck havoc on our financial system given the lack of “comprehensive supervision” of the corporate owners of such institutions. This last proposition ignores the existing legal framework governing all financial institutions, including industrial loan banks, and ignores the substantial power and authority (and indeed belittles the capacity) of the FDIC to supervise, examine and enforce laws, rules and regulations that are intended to assure safety and soundness, as well as prevent abuses that might possibly arise from affiliations between banks and commercial affiliates.

It is this last assertion that I particularly wish to address, that somehow the lack of comprehensive supervision poses a threat to our financial system. I make four major points in response:

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“unintended loophole,” Congress has extensively considered industrial loan banks on numerous occasions, most extensively as part of the Competitive Equality Banking Act in 1987, and again as part of the Gramm-Leach-Bliley Act in 1999.

<sup>4</sup> 12 U.S.C. § 1841(c), where Congress has defined the term “bank” to exclude a variety of institutions that may be owned by commercial firms.

<sup>5</sup> See 12 U.S.C. § 1841(c)(ii)(H)(2), where so-called “non-bank banks” were grandfathered. See Competitive Equality Banking Act of 1987, Pub. L. 100-86, 101 Stat. 554-557, 563, 584 (1987).

<sup>6</sup> See Sec. 24 of the Federal Deposit Insurance Act, as added by Act of December 19, 1991 (Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102-242, § 303(a), 105 Stat. 2236, 2249-2253 (1991), where the FDIC was granted power to allow commercial activities by state chartered banks.

<sup>7</sup> See particularly the provisions of 12 U.S.C. 1843(k) allowing a variety of commercial activities by financial holding companies – in particular merchant banking powers permitting ownership of any commercial entity.

First, industrial loan banks are subject to the same comprehensive framework of supervision and examination as “normal” commercial banks. They have no special powers or authorities; they are exempt from no statute or regulation. They must abide by the requirements of: Sections 23A and B, limiting and controlling transactions with affiliates;<sup>8</sup> Regulation O, governing loans to officers, directors or their related interests;<sup>9</sup> capital requirements;<sup>10</sup> the Prompt Corrective Action safeguards instituted by Congress in the early 1990’s that assure maintenance of adequate capital and impose an ever-increasing level of supervisory control if institutions fail to do so,<sup>11</sup> and all of the other laws, rules and regulations that promote safe and sound banking in this country.

Second, the FDIC has been given full and ample authority to supervise and regulate these institutions, and can exercise the full range of enforcement authorities granted by Congress. I was a participant in the political process that led to Congress’ rewrite of those provisions in 1989, as part of FIRREA,<sup>12</sup> and I personally can attest to the scope of the cease and desist, removal and prohibition, civil money penalty and withdrawal of deposit insurance powers. Given the magnitude of the 1980’s financial debacle and the great concerns in Congress that it never happen again, we at the FDIC at that time worked closely with members of this Committee and others in Congress with the clear intention to give the FDIC and the other bank regulators all of the supervisory and enforcement powers they would ever need to protect the banking system. We wanted to be sure that no future banking failures would be the result of a lack of FDIC authority and tools to address threats to a bank’s safety-and-soundness, including threats that might arise from its nonbanking affiliates.

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<sup>8</sup> 12 U.S.C. §§ 371c, 371c-1.

<sup>9</sup> 12 C.F.R. § 215.1 *et seq.*. See 12 U.S.C. § 1817(k)

<sup>10</sup> 12 C.F.R. § 325.1 *et seq.*

<sup>11</sup> 12 U.S.C. § 1831o. See also 12 C.F.R. § 325.101 *et seq.*

<sup>12</sup> The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183 (1989), extensively revising 12 U.S.C. § 1818.

Importantly, all of these enforcement powers apply with full force to an industrial loan bank, as well as to any officer, director, controlling shareholder or “any other person . . . who participates in the conduct of the affairs of an insured depository institution.”<sup>13</sup> There is no question that to the extent that either the corporate owner of an industrial loan bank or any affiliate of that owner engages in any violation of law, rule or regulation applicable to the industrial loan bank, or has engaged, is engaging or is about to engage in an unsafe or unsound practice relating to the industrial loan bank, the FDIC can bring the full range of enforcement authorities to bear. These remedies can include not only requiring that impermissible or inappropriate activities cease immediately,<sup>14</sup> but also requiring that the condition be remedied and restitution made.<sup>15</sup> Civil money penalties up to one million dollars per day can be imposed,<sup>16</sup> and individuals can be removed from their positions and precluded from having any involvement not only with the industrial loan bank but with *any* insured depository institution.<sup>17</sup> The FDIC can also restrict the activities of the industrial loan bank or any affiliate participating in its affairs, can withdraw the deposit insurance of the industrial loan bank<sup>18</sup> and take any other action it “deems appropriate” in the event of a violation of law, rule or regulation, including in my opinion even forcing the divestiture of the industrial loan bank by its owner.<sup>19</sup>

Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully

<sup>13</sup> See 12 U.S.C. § 1813(u) (definition of “institution-affiliated party”) and 12 U.S.C. § 1818.

<sup>14</sup> 12 U.S.C. §§ 1818(b), (c).

<sup>15</sup> 12 U.S.C. § 1818(b)(6).

<sup>16</sup> 12 U.S.C. § 1818(i).

<sup>17</sup> 12 U.S.C. § 1818(e).

<sup>18</sup> 12 U.S.C. § 1818(a).

<sup>19</sup> As noted above, the FDIC has been given the explicit power to take any action the FDIC “deems appropriate” in the event of a violation of law, rule or regulation or engaging in an unsafe or unsound practice. See 12 U.S.C. § 1818(b)(6)(F). Similarly, the FDIC has been given the power to “place limitations on the activities or functions of an insured depository institution or any institution-affiliated party.” 12 U.S.C. § 1818(b)(7). Finally, the FDIC has been granted “all powers specifically granted by the provisions of this chapter, and such incidental powers as shall be necessary to carry out the powers so granted.” 12 U.S.C. § 1819(a) (Seventh). In my view, the combination of these provisions would give the FDIC ample authority to force the “disaffiliation” between an industrial loan bank and its parent were the relationship between the two create an unsafe or unsound condition.

functioning board of directors designed to assure that the industrial loan bank stands on its own and is not merely an arm of its corporate owner. The industrial loan bank must have adequate capital, operate in a safe and sound fashion, avoid unsafe and unsound practices, have comprehensive policies, controls and procedures, and an effective internal audit program. The FDIC rigorously examines the institution and closely scrutinizes transactions and relationships between the industrial loan bank and its affiliates. It conditions approvals to assure compliance with carefully crafted commitments designed to assure the safe and sound operations of the industrial loan bank. It forcefully uses its enforcement powers, and is not shy about inquiring about any action, transaction or relationship that might potentially affect the insured institution.

Fourth, the experience of the FDIC with respect to industrial loan banks, similar to the experience of the OTS with respect to diversified owners of savings associations, belies any fundamental concerns over threats to the banking system or our economy that might arise from commercial ownership. There have only been two failures of FDIC-insured industrial loan banks owned by holding companies.<sup>20</sup> These holding companies were not commercial (i.e., a non-financial) enterprises. These two failures cost the FDIC roughly \$100 million. Both failed not as a result of any self dealing, conflicts of interest or impropriety by their corporate owners; rather, they failed the “old fashioned way” – poor risk diversification, imprudent lending and poor controls. These two failures stand in sharp contrast to the hundreds of bank failures that operated in holding company structures, many of which cost the FDIC billions of dollars. The list is long and

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<sup>20</sup> The two institutions were Pacific Thrift and Loan (see Press Release, FDIC, FDIC Approves the Assumption of the Insured Deposits of Pacific Thrift and Loan Company (Nov. 19, 1999) available at <http://www.fdic.gov/news/news/press/1999/pr9971.html>) and Southern Pacific Bank (see Press Release, FDIC, FDIC Approves the Assumption of the Insured Deposits of Southern Pacific Bank (Feb. 7, 2003) available at <http://www.fdic.gov/news/news/press/2003/pr1103.html>). There were a series of small industrial loan bank failures between 1986 and 1996. All of these institutions had less than \$60 million in assets and were essentially operated as finance companies. None had “commercial” parents or were part of holding company structures. Most were located in California and could not withstand the banking crisis of the late 1980’s and early 1990’s. They failed, according to the FDIC, as a result of “ineffective risk management and poor credit quality.” FDIC, The FDIC’s Regulation of Industrial Loan Companies: A

sobering – Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on – all of which were subject to the much-vaunted “consolidated supervision” by the Federal Reserve as the holding company regulator that is offered as a cure for something that hasn’t proven to be a problem.

I contrast the foregoing examples with the FDIC’s experience with Consecos’ banks in late 2002. Consecos owned a South Dakota credit card bank as well as a Utah-chartered industrial loan bank. Notwithstanding the highly publicized travails (and bankruptcy) of the parent, the well-capitalized and well-supervised banks did not fail or even particularly suffer as a result of the parent’s problems.<sup>21</sup> The bank-centric approach to regulation and supervision served us all well. Indeed, while I recognize and appreciate the GAO’s perspective that corporate owners of industrial loan banks are not subject to the same degree of consolidated supervision that bank holding companies must endure,<sup>22</sup> the more fundamental question should be whether that degree of consolidated supervision is necessary or even appropriate for owners of banks. Simply put, not everything that can be regulated should be regulated, and a bank-centered model of regulation I believe is better suited to assure innovation and vigorous competition in the banking industry.

As former Federal Reserve Chairman Alan Greenspan once observed:

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Historical Perspective, Supervisory Insights, Summer 2004, [hereinafter Industrial Loan Companies] [http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial\\_loans.html](http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html).

<sup>21</sup> The Consecos example is extensively discussed by Christine Blair in *The FDIC Banking Review, The Future of Banking in America, The Mixing of Banking and Commerce, Current Policy Issues*, January 2005. See Industrial Loan Companies, *supra* note 20.

<sup>22</sup> GAO, GAO-05-621 *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, Report to the Honorable James A. Leach, House of Representatives (2005) available at <http://www.gao.gov/new.items/d05621.pdf>.

The case is weak, in our judgment, for umbrella supervision of a holding company in which the bank is not the dominant unit and is not large enough to induce systemic problems should it fail.<sup>23</sup>

Indeed, having strong owners of depository institutions with diversified sources of income may be more beneficial to our system than artificially limiting ownership to those that are engaged solely in activities so closely related to the business of banking as to be a proper incident thereto<sup>24</sup> or solely in financial activities as deemed permissible by the Federal Reserve.<sup>25</sup>

It may be useful to review a statement made by a former member of the Federal Home Loan Bank Board who served during the thrift crisis period of the late 1980's and who is now a professor at NYU, Lawrence White. In discussing the crisis, he noted the benefits of diversified ownership of thrifts: "The experience of thrift holding companies is instructive. The presence of companies involved in markets as diverse as autos, steel, wood products, retailing, public utilities, insurance and securities as holding company owners of thrifts has not created problems; the same would surely be true if these, or similar companies, had owned banks."<sup>26</sup>

The supposed "ills" that would result from the continued use of industrial loan banks to deliver financial services are mere shibboleths. Critics assert that an industrial loan bank affiliated with a commercial firm would somehow favor its affiliates, discriminate against competitors, or create other unfair advantages unavailable to ordinary banks or bank holding companies. To the contrary:

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<sup>23</sup> Financial Services Restructuring: Hearing Before the Subcomm. On Capital Markets, Securities and Government Sponsored Enterprises of the H. Comm. on Financial Services, 105<sup>th</sup> Cong. (1997) (testimony of Alan Greenspan, Federal Reserve Chairman).

<sup>24</sup> 12 U.S.C. § 1843(c)(8), the provision that primarily defines the permissible direct and indirect activities of bank holding companies.

<sup>25</sup> 12 U.S.C. § 1843(k), the provision adopted as part of Gramm-Leach-Bliley that primarily defines the direct and indirect activities of financial holding companies.

<sup>26</sup> Lawrence J. White, *The S&L Debacle, Public Policy Lessons for Bank and Thrift Regulation* 242 (1991).

· Existing laws preclude use of the industrial loan bank to provide any favorable accommodation to the commercial affiliate. Using an industrial loan bank to advantage a commercial affiliate is no more possible than for a national bank to advantage a financial affiliate. Self dealing and abusive behavior are effectively precluded by existing law and regulation.

· If potential discrimination were an issue, banks should not be affiliated with any type of business. Indeed, if this is our worry, Bank of America should not be affiliated with Banc of America Securities lest the Bank unfairly favor customers of its securities affiliate to the exclusion of customers of Merrill Lynch. Or to use a much more mundane example, might not First National Bank of Small Town America unfairly favor customers of its automobile leasing subsidiary to the exclusion of those that elect to lease from the automobile dealer?

· If we were really concerned about potential for abuses and adverse effects, we might more closely evaluate the propriety of the insurance agent, small business owner, real estate developer or car dealer owning a controlling interest in a bank located in a small community where alternative sources of credit are much more limited. Congress has never acted to preclude affiliations between individuals and banking organizations based upon the business activities of the individual owners, nor should it, as the existing framework of laws and regulations is more than adequate to prevent any abuses.<sup>27</sup>

· Finally, if we were really concerned about the potential dangers of mixing banking and commerce, we should roll back the merchant banking powers granted banking organizations,<sup>28</sup> eliminate the FDIC's power to approve commercial

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<sup>27</sup> It is perhaps telling that the Federal Reserve, which would be in a position to report information on the extent to which business owners hold controlling interests in banking organizations or serve on the board of directors thereof has never, to my knowledge, reported on the nature or extent of such relationships or advised of the potential abuses that might result therefrom.

<sup>28</sup> 12 U.S.C. § 1843(k)(4)(H).

activities for banks<sup>29</sup> and perhaps even strip commercial lending powers from banks, as there are few relationships giving a bank more power over, and a greater interest in, a commercial enterprise than to be the primary source of its funding.

One of the great strengths of our financial system is the sheer number of sources from which financial products and services can be obtained. We have almost 7,500 commercial banks, 1,200 savings institutions and 8,600 credit unions. We have thousands of commercial companies that offer credit to consumers and businesses, and a variety of savings and investment products available outside the banking system. The industrial loan bank model represents only one of many options available for delivering financial services and products. In my experience, companies elect to enter the banking business because they believe that they can meet the needs of their customers. They believe that they can do so profitably. The owners of industrial loan banks are no exception. If they are going to do so, of necessity it will be done in a safe, sound and prudent manner. Congress has given the FDIC the role and responsibility for assuring that this is so, and by any measure, it has done an exceptional job.

As I noted at the outset, I have been involved in providing advisory assistance to the banking regulators in Russia, Egypt and Indonesia, among others. Among the many weaknesses in those systems is the lack of vigorous competition in delivering financial services to the businesses and individuals in their respective countries. The breadth of our markets and the strength of competition within those markets have served us well.

And we should be very clear about a fundamental point. ***Throughout our history to now, there have always been, and federal law has always allowed, affiliations between "banking" and "commerce."*** In our modern era, these relationships have been carefully considered, and accompanied by a statutory and regulatory framework assuring that our regulatory authorities have ample power to protect against abuses and problems.

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<sup>29</sup> 12 U.S.C. § 1831a, as implemented by 12 C.F.R. § 362.1 *et seq.* Pursuant to this authority, the FDIC has allowed banks to engage in commercial and residential real estate development, construct mausoleums and sell crypts and niches, acquire a company engaged in the psychological study of leadership

Moreover, both consumers and our economy have unquestionably benefited from the hundreds of banking-commerce affiliations that have long existed, and continue to exist. Congress should consider very carefully the full implications of any change in law that could choke off these affiliations and deny our financial system the flexibility and innovation that it always has had in the past. It would indeed be unwise to roll back the clock by taking steps to limit healthy and beneficial competition under the guise of advancing an idea that may have an attractive rhetorical resonance, but in fact is simply irrelevant to the issue at hand.

Thank you.

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characteristics and purchase and hold a variety of equity securities. See generally FDIC, Decisions on Bank Applications, <http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html>.

United States Government Accountability Office

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**GAO**

Testimony

Before the Subcommittee on Financial  
Institutions and Consumer Credit,  
Committee on Financial Services, House  
of Representatives

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For Release on Delivery  
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**INDUSTRIAL LOAN  
CORPORATIONS**

**Recent Asset Growth and  
Commercial Interest  
Highlight Differences in  
Regulatory Authority**

Statement of Richard J. Hillman, Managing Director  
Financial Markets and Community Investment



GAO-06-961T

July 12, 2006



Highlights of GAO-06-961T, testimony before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, House of Representatives

## INDUSTRIAL LOAN CORPORATIONS

### Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority

#### Why GAO Did This Study

Since their origin in the early 1900s, industrial loan corporations (ILCs) have grown significantly in size, and some have expressed concern that ILCs may have expanded beyond the original scope and purpose intended by Congress. Others have questioned whether the current regulatory structure for overseeing ILCs is adequate.

This testimony is based on our September 2005 report that, among other things, (1) described the growth and permissible activities of the ILC industry, (2) compared the supervisory authority of the FDIC—the current federal regulator for ILCs—with consolidated supervisors, and (3) described the extent to which ILC parents could mix banking and commerce.

In this testimony GAO is reiterating that Congress should (1) consider options for strengthening the regulatory oversight of ILCs and (2) more broadly consider whether allowing ILCs a greater degree of mixing banking and commerce is warranted or whether other entities should be permitted to engage in this level of activity.

[www.gao.gov/cgi-bin/getrpt?GAO-06-961T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-961T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov).

#### What GAO Found

The ILC industry has experienced significant asset growth and has evolved from once small, limited-purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions. Between 1987 and 2006, ILC assets grew over 3,900 percent from \$3.8 billion to over \$155 billion. In most respects, ILCs may engage in the same activities as other depository institutions insured by the FDIC and are subject to the same federal safety and soundness safeguards and consumer protection laws. Therefore, from an operations standpoint, ILCs pose similar risks to the bank insurance fund as other types of insured depository institutions.

Parents of insured depository institutions that present similar risks to the bank insurance fund are not, however, being overseen by bank supervisors that possess similar powers. ILCs typically are owned or controlled by a holding company that may also own or control other entities. Although FDIC has supervisory authority over an insured ILC, this authority does not explicitly extend to ILC holding companies and, therefore, is less extensive than the authority consolidated supervisors have over bank and thrift holding companies. Therefore, from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company. For example, FDIC's authority to examine ILC affiliates is more limited than a consolidated supervisor. While FDIC asserted that its authority may achieve many of the same results as consolidated supervision, and that its supervisory model has mitigated losses to the bank insurance fund in some instances, FDIC's authority is limited to a particular set of circumstances and may not be used at all times. Further, FDIC's authority has not been tested by a large ILC parent during times of economic stress.

Because of an exception in federal banking law, ILC holding companies can mix banking and commerce more than the holding companies of most other depository institutions. In addition, there are a number of pending applications for deposit insurance with FDIC involving commercial firms, including one of the largest retail firms. While some industry participants assert that mixing banking and commerce may offer benefits from operational efficiencies, empirical evidence documenting these benefits is mixed. Federal policy separating banking and commerce focuses on the potential risks from integrating these functions, such as the potential expansion of the federal safety net provided for banks to their commercial entities. GAO finds it unusual that a limited ILC exemption would be the primary means for mixing banking and commerce on a broader scale and sees merits in Congress taking a look at whether ILCs or other entities should be allowed to engage in this level of activity.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our 2005 report on industrial loan corporations (ILCs).<sup>1</sup> Over the past 10 years, ILCs, particularly when included as part of a holding company structure, have experienced significant growth, now having over \$155 billion in assets; these once small niche lenders have evolved into a diverse industry that includes some large, complex financial institutions. As a result, some have expressed concerns that ILCs may be expanding beyond the original scope and purpose intended by Congress.

The potential entry into banking services by some of the nation's largest retailers has also raised concerns. In 2005, one of the world's largest retailer, Wal-Mart, submitted an application with the Federal Deposit Insurance Corporation (FDIC) to provide federal insurance of deposits in a subsidiary ILC. In May, Home Depot, the nation's largest home improvement retailer, submitted an application for FDIC to approve the purchase of an existing ILC. Proponents assert that these operations will benefit consumers through lower prices or increased access to financial services. Critics, however, say that nonfinancial operations of this size owning an insured ILC pose unnecessary risks to the deposit insurance funds that cannot be adequately addressed under the current regulatory authorities.

My remarks today are primarily based on our 2005 report and focus on three of the report's objectives: the growth and permissible activities of the ILC industry, how FDIC's supervisory authority over ILC holding companies and affiliates compares with a consolidated supervisors' authority; and, the extent to which the ILC charter enables commercial holding companies to mix banking and commerce.<sup>2</sup>

In summary:

ILCs began in the early 1900s as small, state-chartered, loan companies that primarily served the borrowing needs of industrial workers unable to

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<sup>1</sup>GAO, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Washington, D.C.: September 15, 2005).

<sup>2</sup>In preparation for this hearing, we updated our September 2005 report to provide information on the number and total assets of ILCs through March 31, 2006.

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obtain noncollateralized loans from banks. Since then, the ILC industry has experienced significant asset growth and has evolved from small, limited-purpose institutions to a diverse industry that includes some of the nation's largest and more complex financial institutions with extensive access to the capital markets. For example, from 1987 to March 31, 2006, ILC assets have grown over 3,900 percent from \$3.8 billion to over \$155 billion. With one exception contained in federal and one state's banking laws, federally insured ILCs in a holding company structure may generally engage in the same activities as other FDIC-insured depository institutions. Like other FDIC-insured depository institutions, ILCs may offer a full range of loans such as consumer, commercial and residential real estate, and small business loans. As a result, from an operations standpoint, ILCs in a holding company structure pose risks to the Deposit Insurance Fund (the Fund) similar to those posed by other FDIC-insured institutions in holding company structures.<sup>3</sup>

ILCs are state chartered depository institutions. Concerns about them presently exist because of a provision in the Bank Holding Company Act (BHC Act). Under that act, a company that owns or controls a federally insured ILC can conduct banking activities through the ILC without becoming subject to the federal supervisory regime that applies to companies that own or control banks or thrifts. Because these ILCs have federally insured deposits, they are subject to supervision by FDIC as well as their respective state regulators.<sup>4</sup> However, FDIC lacks the explicit authority to regulate ILC parent companies and their activities. Under the BHC Act, the Board of Governors of the Federal Reserve (Board) is responsible for supervising bank holding companies and has established a consolidated supervisory framework for assessing the risks to a depository institution that could arise because of their affiliation with other entities in a holding company structure.<sup>5</sup> The Office of Thrift Supervision has similar authority under the Home Owners Loan Act with

<sup>3</sup>Under 12 U.S.C. 1831a(a), FDIC-insured state banks, a group that includes ILCs, may not engage as principal in any activity that is not permissible for a national bank unless the FDIC has determined that any additional activity would pose no significant risk to the deposit insurance fund and the bank is in compliance with applicable federal capital standards.

<sup>4</sup>Since ILCs are state-chartered financial institutions, they are subject to supervision and regulation by both FDIC and the chartering state's financial regulator.

<sup>5</sup>The Securities and Exchange Commission has approved the applications of five investment banks, including the parent companies of several large ILCs, to be subject to consolidated supervision.

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respect to savings and loan holding companies. The Board and OTS each take a systemic approach to supervising depository institution holding companies and their nonbank subsidiaries and may look across lines of business at operations such as risk management, information technology, or internal audit in order to determine the risk these operations may pose to the insured institution. However, because of an exception under the BHC Act, holding companies of ILCs are not subject to consolidated supervision. Unlike the Board, FDIC does not have specific consolidated supervisory authority over holding companies that conduct banking activities only through ILCs. FDIC has, however, employed what some term a "bank-centric" supervisory approach that primarily focuses on isolating the insured institution from potential risks posed by holding companies and affiliates, rather than assessing these potential risks systemically across the consolidated holding company structure. While FDIC's cooperative working relationships with state supervisors and ILC holding company organizations, combined with its other bank regulatory powers, has allowed FDIC, under certain circumstances, to assess and address the risks to the insured institution and to achieve other results to protect the insurance fund against ILC-related risks, questions remain about the extent to which FDIC's supervisory approach and authority address all risks posed to an ILC from its parent holding company and nonbank affiliates and how well FDIC's approach would fare for large, troubled ILCs during times of stress.

Another area of potential concern about ILCs is the extent to which they can mix banking and commerce through the holding company structure. The BHC Act maintains the historical separation of banking from commerce by generally restricting bank holding companies to banking-related or financial activities.<sup>6</sup> However, because of the ILC exemption in the BHC Act, ILC holding companies, including nonfinancial institutions such as retailers and manufacturers, and other institutions are not subject to federal activities restrictions. Consequently, they have greater latitude to mix banking and commerce than most other financial institutions. While some industry participants have stated that mixing banking and commerce

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<sup>6</sup>As amended by the Gramm-Leach-Bliley Act (GLBA), the BHC Act restricts the activities of bank holding companies to activities "closely related to banking" that were permitted by the Federal Reserve Board as of November 11, 1999. However, bank holding companies that qualify as financial holding companies can engage in additional activities defined in GLBA as activities that are "financial in nature," as well as activities that are incidental to or complementary to financial activity. Pub. L. No. 106-102 §§ 102, 103, *codified* at 12 U.S.C. § 1843(c)(8), (k) (2000 & Supp. 2004).

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may offer benefits from operational efficiencies, the policy of separating banking and commerce was based primarily on reducing the potential adverse consequences that combining these activities may pose. These include the potential expansion of the federal safety net provided for depository institutions to their commercial holding companies or affiliates, increased conflicts of interest within a mixed banking and commercial conglomerate, and increased economic power exercised by large conglomerate enterprises. We found divergent views about the competitive implications of mixing banking and commerce and were unable to identify conclusive empirical evidence that documented efficiencies attributable to mixing banking and commerce. In addition, we found it unusual that use of the ILC exemption under the BHC Act would be the primary means for mixing banking and commerce across a broader scale than afforded to the holding companies of other federally insured depository institutions.

Our report included matters for congressional consideration designed to better ensure that insured institutions providing similar risks to the Fund are subject to federal supervision overseen by banking supervisors that possess similar powers. In this regard, we determined that it would be useful for Congress to consider several options such as eliminating the current BHC Act exception for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor. In addition, we concluded that it would also be beneficial for Congress to more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether allowing ILC holding companies to engage in this activity more than the holding companies of other types of financial institutions is warranted or whether other financial or bank holding companies should be permitted to engage in this level of activity.

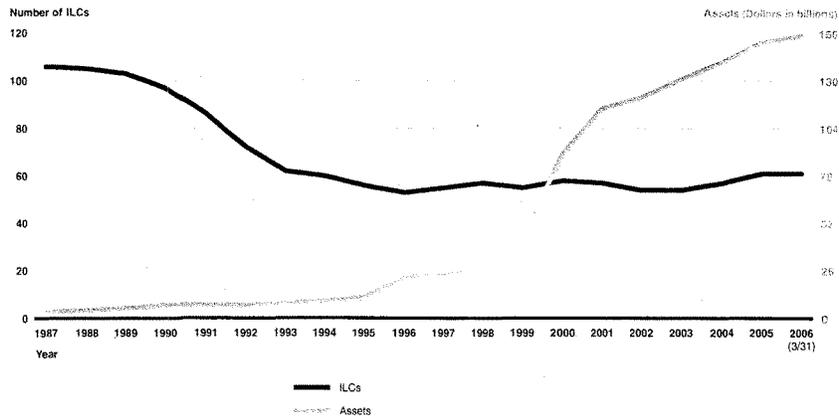
Before discussing the results of our work more fully, I would like to provide a brief overview of the growth of ILCs and compare their permissible activities with those of a state nonmember commercial bank.

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**ILCs Have Grown  
Significantly and Are  
No Longer Small,  
Limited-Purpose  
Institutions**

First, I would like to highlight the significant growth and transformation that has taken place in the ILC industry since 1987. ILCs began in the early 1900s as small, state-chartered loan companies, serving the borrowing needs of industrial workers unable to obtain noncollateralized loans from commercial banks. Since then, the ILC industry has experienced significant asset growth and evolved from small, limited-purpose institutions to a diverse group of insured financial institutions with a variety of business models. Most notably, as shown in figure 1, from 1987 to March 31, 2006, ILC assets have grown over 3,900 percent, from \$3.8 billion to over \$155 billion, while the number of ILCs declined about 42 percent from 106 to 61. In March 2006, 9 ILCs were among the 271 largest financial institutions in the nation with \$3 billion or more in total assets, and one institution had over \$62 billion in total assets. As of March 31, 2006, 6 ILCs owned over 80 percent of the total assets for the ILC industry with aggregate assets totaling over \$125 billion and collectively controlled about \$68 billion in FDIC-insured deposits. During this time period, most of the growth occurred in the state of Utah while the portion of ILC assets in other states declined—especially in California. According to Utah officials, among the reasons ILCs grew in that state was because its laws are “business friendly,” and the state offers a large, well-educated workforce for the financial services industry.

Figure 1: Number and Total Assets of ILCs, 1987 to March 31, 2006



Source: GAO analysis of FDIC Call Report data.

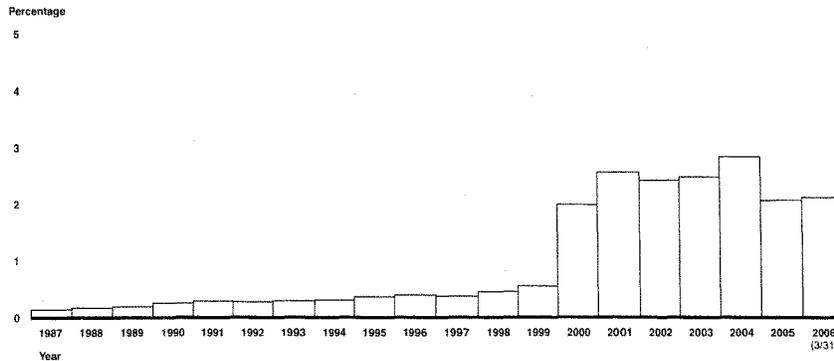
Financial services firms, such as the ILCs owned by Merrill Lynch, USAA Savings Bank, and American Express own and operate the majority of the 61 active ILCs.<sup>7</sup> These ILCs are parts of complex financial institutions with extensive access to capital markets. Other ILCs are part of a business organization that conducts activities within the financial arm of a larger corporate organization not necessarily financial in nature. In addition, other ILCs directly support the holding company organizations' commercial activities, such as the ILCs owned by BMW and Volkswagen. Finally, some ILCs are smaller, community-focused, stand-alone institutions such as Golden Security Bank and Tustin Community Bank.

Although the total amount of estimated insured deposits in the ILC industry has grown by over 600 percent since 1999, as shown in figure 2, these deposits represent less than 3 percent of the total estimated insured

<sup>7</sup>As of March 31, 2006.

deposits in the bank insurance fund for all banks. The significant increase in estimated insured deposits since 1999 was related to the growth of a few ILCs owned by financial services firms. For example, as of March 31, 2006, the largest ILC, owned by Merrill Lynch, held over \$43 billion in estimated FDIC insured deposits.

Figure 2: Percentage of Estimated FDIC Insured Deposits Held by ILCs, 1987 – March 31, 2006



Source: GAO analysis of FDIC Call Report data.

**ILC Business Lines and Regulatory Safeguards Are Similar to Other Insured Financial Institutions**

Next, I would like to briefly compare the permissible activities of ILCs with other insured financial institutions.<sup>8</sup> Federal banking law permits FDIC-insured ILCs to engage in the same activities as other insured depository institutions. However, in order to qualify for the ILC exception in the BHC Act, (and also, we found, because of restrictions in California state law) most ILCs, which are owned by non-BHC Act holding companies, may not accept demand deposits. Other than this exception,

<sup>8</sup>A full comparison is beyond the scope of this testimony. See our 2005 report for a more detailed and comprehensive discussion of ILC lines of business and the regulatory safeguards that apply to ILCs and other insured depository institutions.

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banking laws in California, Nevada, and Utah have undergone changes that generally place ILCs on par with traditional banks in terms of services provided. Thus, as shown in Table 1, like other FDIC-insured depository institutions, ILCs may offer a full range of loans such as consumer, commercial and residential real estate, and small business loans. Further, like a bank, ILCs may "export" their home-state's interest rates to customers residing elsewhere.<sup>9</sup> In effect, this permits ILCs offering credit cards to charge their state's maximum allowable interest rates in other states.<sup>10</sup> In addition, ILCs generally are subject to the same federal regulatory safeguards that apply to commercial banks and thrifts. For example, ILCs are subject to restrictions on transactions between an insured institution and its affiliates under sections 23A and 23B of the Federal Reserve Act that are designed to protect the insured depository institution from adverse transactions with holding companies and affiliates.<sup>11</sup> Sections 23A and 23B generally limit the dollar amount of loans to affiliates and require transactions to be done on an "arms-length" basis.<sup>12</sup> ILCs must also comply with Bank Secrecy Act, Anti-Money Laundering, and Community Reinvestment Act requirements and like other insured depository institutions comply with consumer protection laws.

During our review, we did not identify any banking activities that were unique to ILCs that other insured depository institutions were not permitted to do. The primary difference, as shown in table 1, between ILCs and other FDIC-insured depository institutions is that, to remain outside of the BHC Act, an ILCs must be chartered in the states described in the the

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<sup>9</sup>See 12 U.S.C. § 1831d(a); see also, FDIC General Counsel's Opinion No. 11, Interest Charges by Interstate State Banks, 63 Fed. Reg. 27282 (May 18, 1998).

<sup>10</sup>Nevada and Utah do not cap the interest rates credit card companies can charge. Their usury laws, similar to Delaware and South Dakota, are considered desirable for credit card entities.

<sup>11</sup>Covered transactions are specifically described in section 23A (b)(7)(A) through (E) but generally consist of making loans to an affiliate; purchasing securities issued by an affiliate; purchasing nonexempt assets from an affiliate; accepting securities issued by an affiliated company as collateral for any loan; and issuing a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate. Section 23A also lists several types of transactions that are specifically exempted from its provisions. Under the BHC Act, as amended by GLBA, a depository institution controlled by a financial holding company is prohibited from engaging in covered transactions with any affiliate that engages in nonfinancial activities under the special 10-year grandfather provisions in the GLBA. 12 U.S.C. § 1843 (n)(6).

<sup>12</sup>Section 18(j) of the FDI Act extends the provisions of sections 23A and 23B of the Federal Reserve Act to state nonmember banks. 12 U.S.C. § 1828(j).

ILC exemption and may not accept demand deposits if its total assets are \$100 million or more.<sup>13</sup>

**Table 1: Comparison of Permissible Activities Between State Nonmember Commercial Banks and ILCs in a Holding Company Structure**

Permissible Activities	State Non-member Commercial Bank	Industrial Loan Corporation
Ability to offer full range of loans, including: consumer, commercial real estate, residential real estate, small business, and subprime.	Yes	Yes
Ability to export interest rates.	Yes	Yes
Ability to offer full range of deposits including demand deposits.	Yes	Yes, except in California. However, BHC Act-exempt ILCs may offer demand deposits if either the ILC's assets are less than \$100 million or the ILC has not been acquired after August 10, 1987. <sup>a</sup>

Source: FDIC

<sup>a</sup>ILCs can accept NOW accounts which are insured deposits that, in practice, are similar to demand deposits.

Note: This table was adapted from FDIC's *Supervisory Insights*, Summer 2004. According to the FDIC officials, *Supervisory Insights* was published in June 2004, by FDIC to provide a forum to discuss how bank regulation and policy is put into practice in the field, share best practices, and communicate emerging issues that bank supervisors are facing. This inaugural issue described a number of areas of current supervisory focus at the FDIC, including the ILC charter. According to FDIC officials, *Supervisory Insights* should not be construed as regulatory or supervisory guidance.

Based on an analysis of the permissible activities of ILCs and other insured depository institutions, we and FDIC's Inspector General found that, from

<sup>13</sup>The Competitive Equity Banking Act (CEBA) contains the ILC exemption allowing entities that own or control ILCs to avoid Board regulations as a bank holding company. This exemption applies to ILCs chartered in states that as of March 5, 1987, had in effect or under consideration a statute requiring ILCs to be FDIC insured. According to the FDIC, at the time of the CEBA exemption, six states – California, Colorado, Hawaii, Minnesota, Nevada, and Utah met this requirement. Only ILCs chartered in these “grandfathered” states are eligible for the ILC exemption from the BHC Act.

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an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions. FDIC officials have reported that, like other insured depository institutions, the risk of failure and loss to the Fund from ILCs is not related to the type of charter the institution has. Rather, these officials stated that this risk depends on the institution's business plan and the type of business that the entity is involved in, management's competency to run the bank, and the quality of the institution's risk-management process. Further, FDIC officials stated that their experience does not indicate that the overall risk profile of ILCs is different from that of other types of insured depository institutions, and ILCs do not engage in more complex transactions than other institutions.

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**FDIC's Supervisory Authority Over ILC Holding Companies and Affiliates Is Not Equivalent to Consolidated Supervisors' Authority**

In our 2005 report we compared the supervisory approaches of FDIC and consolidated supervisors, such as the Board and the Office of Thrift Supervision (OTS), and described in detail several differences between FDIC's supervisory authority over ILC holding companies and affiliates and the authority of these consolidated supervisors. Today, I will highlight a few of these differences to illustrate how FDIC's authority over holding companies and affiliates is not as extensive as the authority that these consolidated supervisors have over holding companies and affiliates of banks and thrifts.

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**FDIC and Consolidated Supervisors Use Different Supervisory Approaches**

With some exceptions, companies that own or control FDIC insured depository institutions are subject to a consolidated—or top-down—supervisory approach that is aimed at assessing the financial and operations risks within the holding company structure that may pose a threat to the safety and soundness of the depository institution. Organizations in countries throughout the world recognize consolidated supervision as an accepted approach to supervising organizations that own or control financial institutions and their affiliates. The European Union generally requires consolidated supervision for financial institutions operating in its member states, and the Basel Committee recognizes this

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approach as an essential element of banking supervision.<sup>14</sup> According to this committee, consolidated supervision “includes the ability to review both banking and nonbanking activities conducted by the banking organization, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. Supervisors need to take into account that nonfinancial activities of a bank or group may pose risks to the bank. In all cases, the banking supervisors should be aware of the overall structure of the banking organization or group when applying their supervisory methods.”

In contrast to the top-down approach of bank consolidated supervision, which focuses on depository institution holding companies, FDIC’s supervision focuses on depository institutions. FDIC’s authority extends to affiliates of depository institutions under certain circumstances. Thus, FDIC describes its approach to examining and taking supervisory actions concerning depository institutions and their affiliates (including holding companies), as bank-centric or bottom-up. According to FDIC officials, the objective of this approach is to ensure that the depository institution is insulated and isolated from risks that may be posed by a holding company or its subsidiaries. This objective is similar to the objectives of consolidated supervision. While FDIC officials assert that the agency’s bank-centric approach can go beyond the insured institution, as discussed later in this testimony, this approach is not as extensive as the consolidated supervisory approach in assessing the risks a depository institution faces in a holding company structure.

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**Consolidated Supervisors  
Have More Explicit  
Supervisory Authority  
Over Holding Company  
Affiliates than FDIC**

Because most LLCs exist in a holding company structure, they are subject to risks from the holding company and its subsidiaries, including adverse intercompany transactions, operations risk, and reputation risk, similar to those faced by banks and thrifts existing in a holding company structure. However, FDIC’s authority over the holding companies and affiliates of LLCs is not as extensive as the authority that consolidated supervisors have over the holding companies and affiliates of banks and thrifts. In our

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<sup>14</sup>The Basel Committee on Banking Supervision, established in 1974, is composed of representatives from the central banks or supervisory authorities of major industrial countries in Europe, North America, and Asia, including the United States. This committee has no formal authority but seeks to develop broad supervisory standards and promote best practices in the expectation that each country will implement the standards in ways most appropriate to its circumstances. Implementation is left to each nation’s regulatory authorities.

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2005 report, we described in detail various ways that consolidated supervision offered more explicit authority over holding company affiliates than FDIC's bank centric approach. Today, I will summarize two of these points to illustrate some of the differences in supervisory authority between the FDIC and consolidated supervisors. These two points describe differences in FDIC's and the Board's authority to examine holding companies and their nonbank subsidiaries to assess potential risks to the insured depository institution; and the importance of consolidated supervision standards designed to ensure that the holding company serves as a source of strength to the insured depository institution.

As consolidated supervisors, the Board and OTS have broad authority to examine bank and thrift holding companies (including their nonbank subsidiaries), respectively, in order to assess risks to the depository institutions that could arise because of their affiliation with other entities in a consolidated structure.<sup>15</sup> The Board and OTS have general authority to examine holding companies and their nonbank subsidiaries, subject to some limitations, to assess, among other things, the nature of the operations and financial condition of the holding company and its subsidiaries; the financial and operations risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company; and the systems for monitoring and controlling such risks.<sup>16</sup> This authority is limited with respect to certain types of subsidiaries, such as those regulated by the Securities and Exchange Commission or state insurance regulators, but even those subsidiaries may be examined by the Board under appropriate circumstances where the Board "has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution" or the Board has determined that examination of the subsidiary is necessary to inform the Board of the systems the company has to monitor and control the financial and operational risks within the holding company system that may threaten the safety and soundness of an affiliated depository institution.<sup>17</sup> Also, under

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<sup>15</sup>As noted above, the Securities and Exchange Commission has approved the applications of five investment banks, including the parent companies of several large ILCs, to be subject to consolidated supervision. This prudential supervision regime entails SEC oversight of the risk management and control systems and SEC examination of unregulated entities within the holding companies.

<sup>16</sup>See 12 U.S.C. §§ 1844(c)(2)(A), 1467a., and 12 U.S.C. § 1831v(b).

<sup>17</sup>See 12 U.S.C. § 1844(c)(2)(B).

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the BHC Act, a Board examination of a holding company must, to the fullest extent possible, focus on subsidiaries that could have a materially adverse effect on the safety and soundness of the affiliated depository institution due to the subsidiary's size, condition or activities or the nature and size of transactions between the subsidiary and the depository institution. OTS' examination authority with respect to holding companies is subject to the same limitation.<sup>18</sup> Even with these limitations, both the Board and OTS have direct authority to examine a subsidiary - based solely on characteristics of the subsidiary - in order to assess the condition of an affiliated bank.

In contrast to the consolidated supervisory approaches of the Board and OTS, FDIC's supervisory authority is more limited and does not specifically address the circumstances of an ILC holding company or its nonbank subsidiaries except in the context of a relationship between the ILC and an entity affiliated with it through the holding company structure. Specifically, FDIC's authority to examine state nonmember banks, including ILCs, includes the authority to examine some, but not all, affiliates in a holding company structure. Under section 10(b) of the FDI Act, FDIC, in the course of examining an institution, may examine "the affairs of any affiliate of (the) institution as may be necessary to disclose fully—(i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution."<sup>19</sup> According to FDIC officials, FDIC can use its subpoena and other investigative authorities to obtain information from any affiliate, as well as any nonaffiliate, to determine compliance with applicable law and with respect to any matter concerning the affairs or ownership of an insured institution or any of its affiliates.<sup>20</sup> According to FDIC officials, such an investigation would be triggered by concerns about the insured institution.

Consolidated supervisors have also instituted standards designed to ensure that the holding company serves as a "source of strength" for its insured depository institution subsidiaries. For example, the Board's regulations for bank holding companies include consolidated capital requirements that, among other things, can help protect against a bank's

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<sup>18</sup>See 12 U.S.C. §§ 1467a(b)(4), 1831(a).

<sup>19</sup>See 12 U.S.C. 1820(b)(4)(A).

<sup>20</sup>See 12 U.S.C. § 1820(c).

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exposure to risks associated with its membership in the holding company.<sup>21</sup>

Because FDIC does not supervise institutions affiliated with depository institutions on a consolidated basis, it has no direct authority to impose consolidated supervision requirements, such as capital levels on ILC holding companies. However, FDIC does have authorities that it can use for certain purposes to address risk to depository institutions in a holding company structure. For example, FDIC indicated that it can initiate an enforcement action against an insured ILC and, under appropriate circumstances, an affiliate that qualifies as an institution-affiliated party (IAP) of the ILC if the ILC engages in or is about to engage in an unsafe or unsound practice.<sup>22</sup> An ILC affiliate is an IAP if, among other things, it is a controlling stockholder (other than a bank holding company), a shareholder who participates in the conduct of the affairs of the institution, or an independent contractor who knowingly or recklessly participates in any unsafe or unsound practices.<sup>23</sup> However, FDIC's ability to use this authority to, for example, hold an ILC holding company responsible for the financial safety and soundness of the ILC is less extensive than application of the source of strength doctrine by the Board or OTS under consolidated supervision.

Figure 3 compares some of the differences in explicit supervisory authority between FDIC and consolidated supervisors, specifically the Board and OTS. This figure shows that in two of the eight areas FDIC has examination authority with respect to ILC affiliates that have a relationship with the ILC, as do the Board and OTS. However, we identified six areas where FDIC's explicit authority with respect to ILC holding company affiliates is not as extensive as the explicit authorities of consolidated supervisors to examine, impose capital-related requirements on, or take enforcement actions against holding companies and affiliates of an insured institution. In general, FDIC's supervisory authority over holding companies and affiliates of insured institutions depends on the

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<sup>21</sup>12 C.F.R. Part 225, Appendices B & C.

<sup>22</sup>FDIC has no authority to take action against an ILC affiliate whose activities weaken the holding company, and potentially the ILC, unless the affiliate is an IAP and the IAP participated in conducting the ILC's business in an unsafe or unsound manner, violated a legal requirement or written condition of insurance, or otherwise engaged in conduct subject to enforcement. See 12 U.S.C. § 1818(b).

<sup>23</sup>See 12 U.S.C. § 1813(u).

agency's authority to examine relationships between the institution and its affiliates and FDIC's ability to enforce conditions of insurance and written agreements, to coerce conduct based on the prospect of terminating insurance, and to take enforcement actions against a holding company or affiliate that qualifies as an IAP.<sup>24</sup>

Figure 3: Comparison of Explicit Supervisory Authorities of the FDIC, Board, and OTS

Description of explicit supervisory authority	FDIC*	Board	OTS
Examine the relationships, including specific transactions, if any, between the insured institution and its parent or affiliates.	● <sup>b</sup>	● <sup>b</sup>	● <sup>b</sup>
Examine beyond specific transactions when necessary to disclose the nature and effect of relationship between the insured institution and the parent or affiliate.	● <sup>b</sup>	● <sup>b</sup>	● <sup>b</sup>
Examine the parent or any affiliate of an insured institution, including a parent or affiliate that does not have any relationships with the insured institution or concerning matters that go beyond the scope of any such relationships and their effect on the depository institution.	○	● <sup>b</sup>	● <sup>b</sup>
Take enforcement actions against the parent of an insured institution.	◐ <sup>b,c</sup>	● <sup>b</sup>	● <sup>b</sup>
Take enforcement actions against affiliates of the insured institution that participates in the conduct of affairs of, or acts as agent for, the insured institution.	◐ <sup>b</sup>	● <sup>b</sup>	● <sup>b</sup>
Take enforcement action against any affiliate of the insured institution, even if the affiliate does not act as agent for, or participate in the conduct of, the affairs of the insured institution.	○	● <sup>b</sup>	● <sup>b</sup>
Compel the parent and affiliates to provide various reports such as reports of operations, financial condition, and systems for monitoring risk.	◐ <sup>b,d</sup>	● <sup>b</sup>	● <sup>b</sup>
Impose consolidated or parent-only capital requirements on the parent and require that it serve as a source of strength to the insured depository institution.	◐ <sup>d</sup>	●	●
Compel the parent to divest of an affiliate posing a serious risk to the safety and soundness of the insured institution.	◐ <sup>c</sup>	●	●

- Explicit authority
- ◐ Less extensive authority
- No authority

Sources: GAO analysis of the supervisory authorities of the FDIC, Board, and OTS.  
 \*FDIC may examine an insured institution for interaffiliate transactions at any time and can examine the affiliate when necessary to disclose the transaction and its effect on the insured institution.

<sup>24</sup>In addition to these authorities, we note that measures under the prompt corrective action provisions of the FDIA based on an institution's undercapitalized status include a parental capital maintenance guarantee and the possibility of divestiture of a significantly undercapitalized depository institution or any affiliate. See 12 U.S.C. § 1831e. These measures apply equally to all FDIC insured institutions and their respective regulators.

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<sup>8</sup>The authority that each agency may have regarding functionally regulated affiliates of an insured depository institution is limited in some respects. For example, each agency, to the extent it has the authority to examine or obtain reports from a functionally regulated affiliate, is generally required to accept examinations and reports by the affiliates' primary supervisors unless the affiliate poses a material risk to the depository institution or the examination or report is necessary to assess the affiliate's compliance with a law the agency has specific jurisdiction for enforcing with respect to the affiliate (e.g., the Bank Holding Company Act in the case of the Board). These limits do not apply to the Board with respect to a company that is itself a bank holding company. These restrictions also do not limit the FDIC's authority to examine the relationships between an institution and an affiliate if the FDIC determines that the examination is necessary to determine the condition of the insured institution for insurance purposes.

<sup>9</sup>FDIC may take enforcement actions against institution-affiliated parties of an ILC. A typical ILC holding company qualifies as an institution-affiliated party. FDIC's ability to require an ILC holding company to provide a capital infusion to the ILC is limited. In addition, FDIC may take enforcement action against the holding company of an ILC to address unsafe or unsound practices only if the holding company engages in an unsafe or unsound practice in conducting the affairs of the depository institution.

<sup>10</sup>FDIC maintains that it can achieve this result by imposing an obligation on an ILC holding company as a condition of insuring the ILC. FDIC also maintains it can achieve this result as an alternative to terminating insurance. FDIC officials also stated that the prospect of terminating insurance may compel the holding company to take affirmative action to correct violations in order to protect the insured institution. According to FDIC officials, there are no examples where FDIC has imposed this condition on a holding company as a condition of insurance.

<sup>11</sup>In addition to an enforcement action against the holding company of an ILC in certain circumstances (see note b), as part of prompt corrective action the FDIC may require any company having control over the ILC to (1) divest itself of the ILC if divestiture would improve the institution's financial condition and future prospects, or (2) divest a nonbank affiliate if the affiliate is in danger of becoming insolvent and poses a significant risk to the institution or is likely to cause a significant dissipation of the institution's assets or earnings. However, the FDIC generally may take such actions only if the ILC is already significantly undercapitalized.

Further, in our report we described various areas where FDIC officials asserted that their supervisory approach could achieve similar results to those of consolidated supervision. However, we found that FDIC's authority in each of these areas was less extensive than consolidated supervision because these authorities can only be used under specific circumstances and they do not provide FDIC with a comprehensive supervisory approach designed to detect and address the ILC's exposure to all risks arising from its affiliations in the holding company, such as reputation risk from an affiliate that has no relationship with the ILC. Table 2 provides a summary of what FDIC officials told us about their authority over holding companies and affiliates of insured depository institutions and our analysis of the limitations of these authorities. Today, I will highlight two of these areas: the ability to examine certain ILC affiliates and the ability to terminate deposit insurance to illustrate how FDIC's authority is not equivalent to consolidated supervision of the holding company.

**Table 2: The Extent of Selected FDIC Authorities**

FDIC authority	Extent of authorities
Examine certain ILC affiliates. <sup>1</sup>	Only to determine whether the affiliate has a relationship with the ILC and, if so, to disclose the effect of the relationship on the ILC. The authority does not extend to determining how the affiliate's involvement in the holding company alone might threaten the safety and soundness of the ILC.
Impose conditions on or enter agreement with an ILC holding company in connection with an application for deposit insurance.	Only in connection with an application for deposit insurance and cannot be used to unilaterally impose conditions on an ILC holding company after the application has been approved.
Terminate deposit insurance.	Only if certain notice and procedural requirements (including a hearing on the record before the FDIC Board of Directors) are followed after FDIC determines that <ul style="list-style-type: none"> <li>• the institution, its directors or trustees have engaged in unsafe or unsound practices;</li> <li>• the institution is in an unsafe or unsound condition; or</li> <li>• the institution, its directors or trustees have violated an applicable legal requirement, condition of insurance, or written agreement between the institution and FDIC.</li> </ul>
Obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC. <sup>2</sup>	Could be used if grounds for disapproval exist with respect to the acquirer.
Take enforcement actions against ILC affiliates. <sup>3</sup>	Only if an affiliate is an IAP; and Only if the IAP engages in an unsafe or unsound practice in conducting the business of the ILC or has violated a legal requirement. If the IAP is functionally regulated, FDIC's enforcement grounds are further limited.

Source: GAO analysis of the supervisory authorities stated by FDIC officials.

<sup>1</sup>FDIC's ability to examine ILC affiliates is limited by the meaning of the term "relationship," which is unclear in situations where the ILC and the affiliate do not engage in transactions or share operations. In this respect, FDIC's authority is less extensive than consolidated supervision because (1) the examination authority of consolidated supervisors does not depend on the existence of a relationship and (2) without a relationship, FDIC generally needs the consent of the affiliate to conduct an examination of its operations.

<sup>2</sup>FDIC's ability to obtain written agreements from the acquiring entity in connection with a proceeding to acquire an ILC is limited because certain types of risks, such as reputation risk, could be unrelated to any of the grounds for disapproval of a Change In Bank Control Act notice. Moreover, this ability would not be related to concerns arising after the acquisition is made. Further, some experts stated that it is unlikely that FDIC could require capital-related commitments from a financially strong, well managed commercial enterprise that seeks to acquire an ILC.

<sup>3</sup>In accordance with 12 U.S.C. §§1848a, 1831v(a), FDIC's authority to take action against a functionally regulated IAP is limited to where the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk to the insured institution and the protection is not reasonably possible through action against the institution.

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**FDIC's Examination  
Authority Is Less  
Extensive Than a  
Consolidated Supervisor**

FDIC officials stated that its examination authority is sufficient to address any significant risk to ILCs from holding companies and entities affiliated with the ILC through the holding company structure. For example, FDIC officials told us that it has established effective working relationships with ILC holding companies and has conducted periodic targeted examinations of some ILC holding companies and material affiliates that have relationships with the ILC, which includes those affiliates that are providing services to or engaging in transactions with the ILC. FDIC officials also told us that these targeted reviews of holding companies and affiliates help to assess potential risks to the ILC.

We agree that the scope of FDIC's general examination authority may be sufficient to identify and address many of the risks that holding company and affiliate entities may pose to the insured ILC. However, FDIC's general examination authority is less extensive than a consolidated supervisor's. Because FDIC can examine an ILC affiliate only to determine whether it has a relationship with the ILC and, if so, to disclose the effect of the relationship on the financial institution, FDIC cannot examine ILC affiliates in a holding company specifically to determine how their involvement in the holding company alone might threaten the safety and soundness of the ILC. When there is no relationship between the ILC and the affiliate, FDIC generally would need the consent of the affiliate to conduct an examination of its operations. According to its officials, FDIC could use its subpoena powers and other authorities under section 10(c) of the FDI Act to obtain information, but the use of these powers appears to be limited to examinations or investigations relating to the insured depository institution.<sup>25</sup> In contrast, the examination authorities of the Board and OTS focus on the operations and financial condition of the holding company and its nonbank subsidiaries and specifically on financial and operations risks within the holding company system that can threaten the safety and soundness of a bank subsidiary.<sup>26</sup> To the extent that an affiliate's size, condition, or activities could expose the depository institution to some type of risk, such as reputation risk, where no direct relationship with the bank exists, the consolidated supervisory approach

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<sup>25</sup>See 12 U.S.C. § 1820(c).

<sup>26</sup>See, for example, the focus of bank holding company examinations as prescribed in the BHC Act, 12 U.S.C. § 1844(c)(2).

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is more able to detect the exposure.<sup>27</sup> FDIC's authority does not permit it to examine an affiliate based solely on its size, condition, or activities. While the most serious risk to an ILC would come from holding companies or affiliates that have a relationship with the ILC, the possibility that risks could come from affiliates with no relationship with the ILC should not be overlooked. While no recent bank failures may have resulted from reputation risk, it continues to attract the attention of the FDIC and the Board. Moreover, consolidated supervision requirements can address risks that might not be discernible at a particular point in time, whereas FDIC can exercise its authorities only under certain circumstances, such as when an application for insurance is granted.

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**FDIC's Authority to Terminate Insurance Can Be Exercised in Certain Circumstances**

FDIC officials stated that, even if conditions or agreements were not established in connection with the issuance of an ILC's insurance, the prospect of terminating an institution's insurance can serve to compel the holding company to take measures to enhance the safety and soundness of the ILC. Under the FDI Act, FDIC can initiate an insurance termination proceeding only if certain notice and procedural requirements are followed after a determination by the FDIC that (1) an institution, its directors, or trustees have engaged in or are engaging in an unsafe or unsound practice; (2) an institution is in an unsafe or unsound condition; or (3) the institution, its directors, or trustees have violated an applicable legal requirement, a condition imposed in connection with an application by the depository institution, or a written agreement between the institution and FDIC.<sup>28</sup> In addition, termination proceedings must be conducted in a hearing on the record, documented by written findings in support of FDIC's determination, and are subject to judicial review.<sup>29</sup> FDIC officials told us that if the grounds for termination exist, FDIC can provide the holding company of a troubled ILC with an opportunity to avoid termination by agreeing to measures that would eliminate the grounds for termination. These measures could include an agreement to infuse capital

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<sup>27</sup>See 12 U.S.C. 1844(c)(1)(C) Board examinations, to fullest extent possible, are to be limited to examinations of holding company subsidiaries whose "size, condition, or activities" could adversely affect the affiliated bank's safety and soundness or where the nature and size of transactions between the affiliate and the bank could have that effect.

<sup>28</sup>The procedural requirements include notifying the appropriate federal or state banking supervisor of FDIC's determination for the purpose of securing a correction by the institution. 12 U.S.C. § 1818(a)(2)(A).

<sup>29</sup>See 12 U.S.C. § 1818(a)(3)(5).

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into the ILC or provide reports about the holding company and its affiliates. According to FDIC officials, the prospect of terminating insurance is usually sufficient to secure voluntary corrective action by a holding company to preclude the occurrence of an unsafe or unsound practice or condition or restore the institution to a safe and sound financial condition. FDIC officials stated that FDIC has notified insured institutions that it intended to terminate deposit insurance 184 times. Between 1989 and 2004, FDIC initiated formal proceedings to terminate deposit insurance in 115 of these cases because necessary corrections were not immediately achieved and terminated deposit insurance in 21 of these cases. In 94 of these 115 instances, corrective actions were taken, and the deposit insurance was not terminated.

As demonstrated by the number of institutions that took measures to enhance the safety and soundness of the insured depository institution, the threat of insurance termination has been an effective supervisory measure in many instances. However, FDIC's ability to use the possibility of insurance termination to compel the holding company to enhance the safety and soundness of the insured institution is limited. For example, because the statutory grounds for termination relate to the condition of the institution and practices of its directors or trustees, the prospect of termination would not be based solely on the condition or operations of an institution's affiliate. While conditions could exist in the holding company that might threaten the holding company and thereby indirectly threaten an ILC, these conditions would not serve as grounds for termination of insurance unless they caused the institution to be in an unsafe or unsound condition. Further, unlike the consolidated supervision approach, FDIC insurance termination authority does not give it power to require a holding company or any of its nonbank affiliates to change their operations or conditions in order to rehabilitate the ILC. The extent to which FDIC could enter into an agreement with a holding company would depend on whether the holding company has an incentive to retain the institution's insured status and/or the resources to take the action FDIC seeks.

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#### FDIC Actions May Help Mitigate Potential Risks

FDIC's bank-centric, supervisory approach has undergone various modifications to its examination, monitoring, and application processes, designed to help mitigate the potential risks that FDIC-examined institutions, including ILCs in a holding company structure, can be exposed to by their holding companies and affiliates. For example, FDIC revised the guidance for its risk-focused examinations to, among other things, provide additional factors that might be considered in assessing a holding company's potential impact on an insured depository institution

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affiliate. These changes may further enhance FDIC's ability to supervise the potential risks that holding companies and affiliates can pose to insured institutions in a holding company structure, including ILCs. In addition, FDIC's application process may also help to mitigate risks to ILCs with foreign holding companies and affiliates. While FDIC has provided some examples where its supervisory approach effectively protected the insured institution and mitigated losses to the bank insurance fund, questions remain about whether FDIC's supervisory approach and authority over BHC Act-exempt holding companies and affiliates addresses all risks to the ILC from these entities.

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**FDIC's Supervisory Model and Authority Over BHC Act-Exempt Holding Companies and Nonbank Affiliates Has Been Tested on a Limited Basis in Relatively Good Economic Times**

Although there have been material losses to the bank insurance fund resulting from two ILC failures in the past 7 years, the remaining 19 ILC failures occurred during the banking crisis in the late 1980s and early 1990s. Most of these ILCs were small California Thrift and Savings and Loan companies that, according to FDIC, had above-average risk profiles. FDIC's analysis of bank failures during this time period indicates that California experienced deteriorating economic conditions and a severe decline in the real estate industry, which contributed to the failure of 15 ILCs in that state. As previously discussed, FDIC has since implemented changes to its supervisory approach and has told us about some recent examples where, according to FDIC, its supervisory approach—including its influence and authority as the provider of deposit insurance—has effectively protected the insured institution and prevented losses to the Fund. However, all of the ILCs that failed since the late 1980s, as well as those ILCs that became troubled and FDIC took corrective action, were relatively small in size compared with some of the large ILCs that currently dominate the industry. FDIC has no experience using its supervisory approach to mitigate potential losses from troubled ILCs that would qualify for supervision under its Large Bank program.<sup>30</sup>

FDIC's supervisory model and authority over BHC Act-exempt ILC holding companies and affiliates has emerged during a time when the banking industry has experienced relatively good times. Former FDIC Chairman Donald Powell described the past decade as a "golden age" of banking. The past 10 years can be characterized by stable economic growth, which has contributed to strong industry profitability and capital positions.

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<sup>30</sup>FDIC's large bank program provides an on-site presence at depository institutions with total assets greater than \$10 billion or because of their size, complexity, and risk profile.

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During the past 8 years, only 35 financial institutions protected by the Fund have failed, and FDIC has reported that insured institutions' earnings for 2004 set a new record for the fifth consecutive year and that the industry's equity capital ratio is at its highest level since 1938.<sup>31</sup> In contrast, 1,373 financial institutions protected by the Fund failed between 1985 and 1992 due to, among other things, poor management and poor lending practices.

How FDIC's supervisory approach would fare for large, troubled ILCs during an adverse external environment is not clear and the test of supervision is its effectiveness during periods of stress. We have long advocated comprehensive regulation of financial services holding companies on both a functional and consolidated basis in order to assess how risks in other components of the holding company may affect the insured bank. We have stated that capital standards for both insured banks and their holding companies should adequately reflect all major risks. Our belief in the importance of consolidated supervision and consolidated capital standards is partly based on the fact that most bank holding companies are managed on a consolidated basis, with the risks and returns of various components being used to offset and enhance one another. In addition, past experience has shown that, regardless of whether regulatory safeguards—such as sections 23A and 23B limitations—are set properly, even periodic examinations cannot ensure that regulatory safeguards can be maintained in times of stress.

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<sup>31</sup>Equity capital or financing is money raised by a business in exchange for a share of ownership in the company. Financing through equity capital allows a business to obtain funds without incurring debt or without having to repay a specific amount of money at a particular time. The equity capital ratio is calculated by dividing total equity capital by total assets.

**ILCs May Offer Commercial Holding Companies a Greater Ability to Mix Banking and Commerce than Other Insured Depository Institutions, but Views on Competitive Implications Are Mixed**

ILC holding companies and their affiliates may be able to mix banking and commerce more than other insured depository institutions because the holding companies and affiliates of ILCs are not subject to business activity limitations that generally apply to insured depository institution holding companies. Except for a limited category of firms, such as grandfathered unitary thrift holding companies and companies that own limited purpose credit card banks (CEBA credit card banks), entities that own or control insured depository institutions generally may engage, directly or through subsidiaries, only in activities that are financial in nature.<sup>32</sup> Because of a provision in the ILC exception in the BHC Act, an entity can own or control a qualifying ILC without facing the activities restrictions imposed on bank holding companies and nonexempt thrift holding companies. As a result, the holding companies and affiliates of some ILCs and other subsidiaries are allowed to engage in nonfinancial, commercial activities.

Today, nonfinancial, commercial firms in the automobile, retail, and energy industries, among others, own ILCs. As of March 31, 2006, 10 ILCs with total assets of about \$ 3.6 billion directly support their parent's commercial activities. However, these figures may understate the total number of ILCs that mix banking and commerce because 5 other ILCs are owned by commercial firms that were not necessarily financial in nature. Because these corporations, on a consolidated basis, include manufacturing and other commercial lines of business with the financial operations of their ILC, we determined that these entities also mixed banking and commerce. Thus, we found that, as of March 31, 2006, approximately 15 of the 61 active ILCs were owned or affiliated with commercial entities, representing about \$13.2 billion, (about 8.5 percent) and \$8.2 billion (about 9.7 percent) of total ILC industry assets and estimated insured deposits, respectively.<sup>33</sup> In addition, there are a number

<sup>32</sup>See 12 U.S.C. §§ 1843, 1467a(c). As previously discussed, grandfathered unitary thrift holding companies are not subject to these activities restrictions. Limited purpose credit card banks also are exempt from the BHC Act. See 12 U.S.C. § 1841(c)(2)(F).

<sup>33</sup>When determining the current levels of mixed banking and commerce within the ILC industry, we considered only ILCs owned or affiliated with explicitly nonfinancial, commercial firms. Because some owners and operators of ILCs are engaged in business activities that are generally financial in nature, but still may not meet the statutory requirements of a qualified bank or financial holding company, officials from the Federal Reserve Board noted that they interpret the level of mixed banking and commerce among ILCs may be greater than 8.5 percent of industry assets and 9.7 percent of industry estimated insured deposits.

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of pending applications for deposit insurance with FDIC involving commercial firms, including one of the largest retail firms.

Regulators and practitioners with whom we spoke with also noted, however, that several other major industrial nations do allow a greater mixing of banking and commerce than does the United States. For example, in Europe there are generally no limits on a nonfinancial, commercial firm's ownership of a bank. However, the European Union has mandated consolidated supervision. Japan has also allowed cross-ownership of financial services firms, including banks and commercial firms, permitting development of industrial groups or keiretsu that have dominated the Japanese economy. These groups generally included a major or "lead" bank that was owned by other members of the group, including commercial firms, and that provided banking services to the other members. The experience of these nations provides some empirical evidence of the effects of increased affiliation of banking and commercial businesses, particularly pointing to the importance of maintaining adequate credit underwriting standards for loans to affiliated commercial businesses. Problems in Japan's financial sector, notably including nonperforming loans, often to commercial affiliates of the banks, have contributed in part to the persistent stagnation of the Japanese economy beginning in the 1990s. However, important differences between the financial and regulatory systems of these nations and the United States, and limitations in research into the effects of these affiliations, limit many direct comparisons.

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**Mixing Banking and  
Commerce Presents Both  
Potential Risks and  
Benefits**

The policy generally separating banking and commerce is based primarily on limiting the potential risks that may result to the financial system, the deposit insurance fund, and taxpayers. We have previously reported that the potential risks that may result from greater mixing of banking and commerce<sup>34</sup> include the (1) expansion of the federal safety net provided for banks to their commercial entities, (2) increased conflicts of interest within a mixed banking and commercial conglomerate, and (3) increased economic power exercised by large conglomerate enterprises. However, generally the magnitudes of these risks are uncertain and may depend, in part, upon existing regulatory safeguards and how effectively banking regulators monitor and enforce these safeguards.

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<sup>34</sup>GAO, *Separation of Banking and Commerce*, GAO/OCE/GGD-97-16R (Washington, D.C.: Mar. 17, 1997).

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The federal government provides a safety net to the banking system that includes federal deposit insurance, access to the Federal Reserve's discount window, and final riskless settlement of payment system transactions. According to Federal Reserve officials, the federal safety net in effect provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds because the system of federal deposit insurance shifts part of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers. The system of federal deposit insurance can also create incentives for commercial firms affiliated with insured banks to shift risk from commercial entities that are not covered by federal deposit insurance to their FDIC-insured banking affiliates. As a result, mixing banking and commerce may increase the risk of extending the safety net, and any associated subsidy, may be transferred to commercial entities. This risk, however, may be mitigated by statutory and regulatory safeguards between the bank and their commercial affiliates such as requirements for arms-length transactions and restrictions on the size of affiliate transactions under section 23A and 23B of the Federal Reserve Act. However, during times of stress, these safeguards may not work effectively—especially if managers are determined to evade them.

The mixing of banking and commerce could also add to the potential for increased conflicts of interest and raise the risk that insured institutions may engage in anticompetitive or unsound practices. For example, some have stated that, to foster the prospects of their commercial affiliates, banks may restrict credit to their affiliates' competitors, or tie the provision of credit to the sale of products by their commercial affiliates. Commercially affiliated banks may also extend credit to their commercial affiliates or affiliate partners, when they would not have done so otherwise. Additionally, some have also stated that mixing banking and commerce could promote the formation of very large conglomerate enterprises with substantial amounts of economic power. If these institutions were able to dominate some markets, such as the banking market in a particular local area, they could impact the access to bank services and credit for customers in those markets.

Other industry observers envision potential benefits from mixed banking and commerce, including allowing banks, their holding companies, and customers to benefit from potential increases in the scale of operations, which lowers the average costs of production, known as economies of scale, or from potential reductions in the cost of producing goods that share common inputs, known as economies of scope, and enhanced product and geographic diversification. Because banks incur large fixed

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costs when setting up branches, computer networks, and raising capital, these institutions may benefit from the selected economies of scale and scope that could result from affiliations with commercial entities. Mixed banking and commercial entities may also benefit from product synergies that result from affiliation. For example, firms engaged in both the manufacturing and financing of automobiles may be able to increase sales and reduce customer acquisition costs by combining manufacturing and financing. Enhanced product and geographic diversification could also reduce risk to the combined entity.

However, during our search of academic and other literature, we were unable to identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce. One primary factor in the lack of empirical evidence may be that, because of the policy generally separating banking and commerce, few institutions are available for study.

Because GLBA removed several restrictions on the extent to which conglomerates could engage in banking and nonbanking financial activities, such as insurance and securities brokerage, some analysts had expected that conglomeration would intensify in the financial services industry after GLBA. However, as yet, this does not seem to have happened. The reasons vary. Many banks may not see any synergies with insurance underwriting. Additionally, it may be that many mergers are not economically efficient, the regulatory structure set up under GLBA may not be advantageous to these mergers, or, it is simply too soon to tell what the impact will be. Further, a general slowdown occurred in merger and acquisition activity across the economy in the early 2000s, which may also be a contributing factor to the pace of industry conglomeration post-GLBA.

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## Concluding Remarks

As we stated in our 2005 report, ILCs have significantly evolved from the small, limited purpose institutions that existed in the early 1900s. Because of the significant recent growth and complexity of some ILCs, the industry has changed since being granted an exemption from consolidated supervision in 1987, and some have expressed concerns that ILCs may have expanded beyond the original scope and purpose intended by Congress. The vast majority of ILCs have corporate holding companies and affiliates and, as a result, are subject to similar risks from holding company and affiliate operations as banks and thrifts and their holding companies. However, unlike bank and thrift holding companies, most ILC holding companies are not subject to federal supervision on a

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consolidated basis. While FDIC has supervisory authority over an insured ILC, it does not have the same authority to supervise ILC holding companies and affiliates as a consolidated supervisor. While the FDIC's authority to assess the nature and effect of relationships between an ILC and its holding company and affiliates does not directly provide for the same range of examination authority, its cooperative working relationships with state supervisors and ILC holding company organizations, combined with its other bank regulatory powers, has allowed the FDIC, under limited circumstances, to assess and address the risks to the insured institution and to achieve other results to protect the insurance fund against ILC-related risks. However, FDIC's supervisory approach over ILC holding companies and affiliates has not been tested by a large ILC parent during periods of economic stress. Moreover, we are concerned that insured institutions posing similar risks to the Deposit Insurance Fund are not being overseen by bank supervisors that possess similar powers. Because of these differences in supervision, we found that, from a regulatory standpoint, ILCs in a holding company structure may pose more risk of loss to the Fund than other types of insured depository institutions in a holding company structure. To better ensure that supervisors of institutions with similar risks have similar authorities, Congress should consider various options such as eliminating the current exclusion for ILCs and their holding companies from consolidated supervision, granting FDIC similar examination and enforcement authority as a consolidated supervisor, or leaving the oversight responsibility of small, less complex ILCs with the FDIC, and transferring oversight of large, more complex ILCs to a consolidated supervisor.

In addition, although federal banking law may allow ILC holding companies to mix banking and commerce to a greater extent than holding companies of other types of depository institutions, we were unable to identify any conclusive empirical evidence that documented operational efficiencies from mixing banking and commerce, and the views of bank regulators and practitioners were mixed. Nevertheless, the potential risks from combining banking and commercial operations remain. These include the potential expansion of the federal safety net provided for banks to their commercial entities, increased conflicts of interest within a mixed banking and commercial conglomerate, and increased economic power exercised by large conglomerate enterprises. In addition, we find it unusual that this limited exemption for ILCs would be the primary means for expanding the mixing of banking and commerce than afforded to the holding companies of other financial institutions. Because it has been a long time since Congress has focused on the potential advantages and disadvantages of mixing banking and commerce and given the rapid

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growth of ILC assets and a potential for increased attractiveness of the ILC charter, we concluded in our 2005 report that Congress should more broadly consider the advantages and disadvantages of mixing banking and commerce to determine whether continuing to allow ILC holding companies to engage in this activity more than the holding companies of other types of financial institutions is warranted or whether other financial or bank holding companies should be permitted to engage in this level of activity.

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Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or other Members may have at the appropriate time.

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**GAO Contacts and  
Staff  
Acknowledgments**

For further information on this testimony, please contact Richard Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov). Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony included Dan Blair, Tiffani Humble, James McDermott, Dave Pittman, and Paul Thompson.

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*Testimony of*

Arthur C. Johnson

Chairman and Chief Executive Officer, United Bank of Michigan

*On Behalf of the*

**AMERICAN BANKERS ASSOCIATION**

*Before the*

Subcommittee on Financial Institutions and Consumer Credit

*Of the*

Committee on Financial Services

United States House of Representatives

July 12, 2006

Testimony of Arthur C. Johnson  
Chairman and Chief Executive Officer, United Bank of Michigan  
on Behalf of the  
American Bankers Association  
before the  
Subcommittee on Financial Institutions and Consumer Credit  
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Committee on Financial Services  
United States House of Representatives

July 12, 2006

Mr. Chairman and members of the Subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of the United Bank of Michigan, headquartered in Grand Rapids, Michigan. I also serve as Chairman of the Government Relations Council of the American Bankers Association (“ABA”), and I am testifying today on behalf of the ABA. The ABA brings together all categories of financial institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA’s views on the regulation of industrial loan corporations (“ILCs”). The ILC industry has changed dramatically since Congress last enacted legislation concerning the ownership of ILCs. Indeed, the seeds planted by that law have grown into a garden in severe need of tending.

In my statement today I would like to make three points:

- First, the ILC industry of today bears little resemblance to the ILC industry of 1987, the year the current ILC law was enacted.

- Second, the current regulatory approach is inconsistent with the policy of separating banking from non-financial commerce.
- Third, Congress should act to ensure that potential problems do not become real.

These points are addressed in further detail below.

#### **I. THE ILC INDUSTRY OF TODAY BEARS LITTLE RESEMBLANCE TO THE ILC INDUSTRY OF 1987, THE YEAR THE CURRENT ILC LAW WAS ENACTED.**

The current exemption from the Bank Holding Company Act for companies that own ILCs was enacted in 1987. Since that time the ILC industry has experienced explosive growth, and the assumptions upon which the exemption was predicated no longer remain valid.

ILCs began in the early 1900s to provide uncollateralized consumer loans to low- and moderate-income workers unable to obtain such loans from existing commercial banks.<sup>1</sup> ILCs initially were not eligible for federal deposit insurance when the FDIC was created. However, the FDIC changed its policy over time until, with passage of the Garn-St Germain Depository Institutions Act of 1982, all ILCs were granted eligibility for deposit insurance, as were the thrift certificates they offered in lieu of deposits.<sup>2</sup> Some states thereafter *required* ILCs to obtain FDIC insurance as a condition of chartering, with the result that by 1987, the FDIC insured most ILCs and shared supervision with their state charterers.

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<sup>1</sup> GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

<sup>2</sup> Pub. L. No. 97-320 § 703.

In 1987, Congress enacted the Competitive Equality Banking Act (“CEBA”), one of the primary purposes of which was to close the “non-bank bank” loophole. Because the definition of “bank” in the Bank Holding Company Act at that time included only entities that offered commercial loans *and* accepted demand deposits, a number of large retail commercial entities acquired institutions that made loans but did not offer demand deposits. This approach enabled them to avoid supervision as bank holding companies while offering banking services on an interstate basis.

When Congress amended the definition of “bank” in the Bank Holding Company Act to eliminate the non-bank bank loophole, it also provided an exemption from that definition for certain ILCs that:

- 1) do not accept demand deposits that can be withdrawn by check or similar means for payment to third parties;
- 2) have total assets of less than \$100 million; or
- 3) have not undergone a change in control after 1987.<sup>3</sup>

The exemption applied to a comparatively few, small institutions. In 1987, most ILCs had less than \$50 million in assets. The few states that were able to charter ILCs were not promoting the charter. In fact, Utah had a moratorium at the time on the creation of new ILCs. In short, there was no significant risk that problems caused by mixing banking and non-financial commerce would arise from the ILCs that existed at the time that the exemption was codified.

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<sup>3</sup> The exemption applies only to ILCs chartered in states that in 1987 required ILCs to have deposit insurance, namely, California, Colorado, Hawaii, Minnesota, Nevada and Utah.

Almost twenty years later, the characteristics of ILCs have changed dramatically. Between 1987 and the first quarter of 2006, aggregate ILC assets have grown almost 4,000 percent, from \$3.8 billion to over \$155 billion, with the average ILC holding close to \$2.6 billion in assets. According to a 2005 report by the Government Accountability Office (GAO), only seven states have active ILCs, and California, Nevada, and Utah charter more than half, with the state of Utah leading in ILC asset growth.<sup>4</sup> There are a total 60 ILCs to date with another 13 applications for federal deposit insurance pending.

This growth is not by accident. In 1997, Utah lifted its moratorium on new charters, permitted ILCs to call themselves “banks,” and authorized them to engage in virtually all of the powers of state-chartered banks. Today the Utah Department of Financial Institutions touts the benefits of ILCs on its web site, stating --

Generally, IBs [*i.e.*, industrial banks] are authorized to make all kinds of consumer and commercial loans and to accept federally insured deposits, but not demand deposits if they have total assets greater than \$100 million. \* \* \* The flexibility of an IB charter has made it an attractive vehicle for some large and well-known corporations. IBs offer a versatile depository charter for companies that are not permitted to, or that choose not to, become subject to the limitations of the Bank Holding Company Act or the Glass Steagall Act.<sup>5</sup>

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<sup>4</sup> The GAO report states that “As of December 31, 2004, there were 29 ILCs, representing 82 percent of the ILC industry assets, with headquarters in Utah. According to officials at the Utah Department of Financial Institutions, ILC growth in Utah occurred because other state laws are not as ‘business friendly’ as Utah. These officials also stated that Utah has state usury laws that are more desirable than many other states and the state offers a large well-educated workforce for the financial institutions industry.” GAO-05-621, *Industrial Loan Companies*, September 15, 2005 at 19.

<sup>5</sup> <http://www.dfi.utah.gov/whatisIB.htm>.

Today, an ILC—even one with assets in excess of the \$100 million threshold codified in CEBA—may effectively compete with full-service insured depository institutions. As recently observed by Chairman Alan Greenspan, ILCs may engage in the “full range of commercial, mortgage, credit card and consumer lending activities; offer payment-related services, including Fedwire, automated clearing house and check clearing services, to affiliated and unaffiliated persons; [and] accept time and savings deposits, including certificates of deposit from any type of customer.”<sup>6</sup>

The assumptions underlying the current system of regulating today’s ILCs – namely, that they are small lenders meeting the needs of the underserved – are no longer valid. Industrial banks do not resemble the small ILC of yesteryear that was created to make uncollateralized loans to industrial workers. Instead, they are increasingly large, sophisticated commercial firms that have identified a loophole that allows them to own an insured depository institution without becoming a bank holding company.

## **II. THE CURRENT REGULATORY APPROACH IS INCONSISTENT WITH THE POLICY OF SEPARATING BANKING FROM NON-FINANCIAL COMMERCE.**

Our banking laws historically have provided for the separation of banking and non-financial commerce to protect depository institutions, the federal deposit insurance fund, and our financial system in general from a variety of potential risks. Indeed, over the past 50 years, Congress has repeatedly acted to close avenues through which non-financial commercial entities could own depository institutions.

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<sup>6</sup> Letter from Federal Reserve Board Chairman Alan Greenspan to Congressman James Leach dated January 20, 2006.

The Bank Holding Company Act of 1956 prohibited companies that owned two or more banks from engaging in non-financial commercial activities. In 1970, Congress extended that prohibition to companies that owned only a single bank. In 1987, Congress closed the “non-bank bank” loophole. Most recently, the Gramm-Leach-Bliley Act prohibited new non-financial commercial entities’ acquisition of a single savings association.

In each of these instances, Congress looked at whether it was appropriate for companies to engage in banking while engaging in a significant way in non-financial commerce. And in each instance, Congress removed the option while giving due consideration to the equities of those holding existing investments.

The ABA has consistently supported these Congressional actions. In September of last year, our Board of Directors unanimously reaffirmed ABA’s position that non-financial commercial firms should not be engaged in acquiring and chartering banks, including ILCs.

It would be odd for Congress repeatedly and consistently to close provisions that permitted non-financial commercial firms to own insured depository institutions and yet leave open an outdated provision of law that could undermine the consistent legislative steps that have prohibited the mixing of banking and commerce. Left unchecked, this regulatory approach risks systemic problems.

**III. CONGRESS SHOULD ACT NOW TO ENSURE THAT POTENTIAL PROBLEMS DO NOT BECOME REAL.**

There are a number of potential problems stemming from the current approach to regulating ILCs. These problems, if left unattended, have the potential to erode unalterably the separation of banking from non-financial commerce that has served our country so well.

The rationale for maintaining a separation of banking from non-financial commerce is clear. The banking industry is carefully regulated for safety and soundness and systemic risk because of the critical nature of the industry to the functioning of our economy. By contrast, non-financial firms are regulated under differing programs and for a variety of purposes. However valuable these other purposes might be, they must not be allowed to compete for attention in the executive offices or in the board room with the fundamental purposes of banking institutions.

Blending banking and non-financial commerce raises a host of issues. Among these is the potential for a conflict of interest, particularly in decisions concerning extensions of credit. A non-financial commercial firm could pressure or otherwise encourage a bank subsidiary to grant customers of the firm credit on favorable terms or refuse to grant credit or stiffen credit terms to the firm's competitors or their customers. Credit decisions based on factors other than the creditworthiness of the borrower and other relevant, customary banking considerations have the potential to threaten the safety and soundness of the bank and pose a related risk to the federal deposit insurance system, while encouraging abusive financial practices. Allocating credit in this way runs counter to the general purposes of a

bank charter and its obligations to customers, and could be particularly aggravating in smaller communities.

Additional issues may arise when a bank, in order to cope with reputational risk from a non-financial parent or non-financial affiliate, might be tempted to make funding decisions to support the affiliate or its customers that are not in the best financial interests of the bank.

In short, a non-financial commercial firm, unaccustomed to operating within the heavily regulated banking environment, presents a greater risk that it will use a subsidiary bank to serve the firm's commercial purposes instead of serving as a source of strength for the bank.

The current regulatory landscape, by creating incentives to obtain a bank through an ILC charter, increases the likelihood that these risks will become problems. Non-financial commercial firms that own ILCs are outside the consolidated supervision of a bank regulator. And they are not subject to bank capital requirements. These competitive advantages may have been tolerable when CEBA was passed, but today they are not.

The most effective way to remedy the current situation is to limit ownership of insured depository institutions to companies that are financial in nature. Thus, the ABA recommends that Congress close the ILC loophole by requiring any company that seeks to establish or acquire an ILC be a financial firm, with the determination based on a specified percentage of revenues derived from activities that are financial in nature or incidental or complementary to a financial activity.

This approach would apply to non-financial commercial firms that currently own an ILC but that in all likelihood could not meet a test based on revenues derived from financial activities. The ABA recognizes that legislation affecting ILCs, like legislation that has closed previous loopholes, likely would grandfather these firms in an effort to strike a balance going forward. However, we urge Congress to bring any grandfathered institution within the jurisdiction of a federal bank regulator and vest that regulator with the full range of supervisory and enforcement tools necessary to protect the insured depository institution or its holding company.

#### **CONCLUSION**

The program governing ILCs is broken. ILCs are playing an increasingly important role in our nation's banking system, a role that was not evident when Congress created the ILC loophole. It is time to fix the law before the current approach leads to serious problems.

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STATEMENT OF

**DOUGLAS H. JONES  
ACTING GENERAL COUNSEL  
FEDERAL DEPOSIT INSURANCE CORPORATION**

on

**INDUSTRIAL LOAN COMPANIES:  
A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES**

before the

**COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES**

**July 12, 2006  
Room 2128 Rayburn House Office Building**

Chairman Bachus, Representative Sanders and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning industrial loan companies (ILCs). As the primary federal supervisor for ILCs, the FDIC has considerable experience with these entities. Although I cannot comment on specific pending applications, my testimony this morning will discuss the history and characteristics, current industry profile and supervision of ILCs.

### **History and Characteristics**

Industrial loan companies and industrial banks are state-chartered banks supervised by their chartering states and the FDIC, which is their primary federal regulator. The ILC charter has existed since 1910, when Arthur J. Morris established the Fidelity Savings and Trust Company of Norfolk, Virginia. This was the first of the Morris Plan Companies, which were also known as industrials, industrial banks, or thrift and loans. These institutions were chartered and supervised by the states and operated more or less like finance companies, providing loans to wage earners who could not otherwise obtain credit.

The FDIC has been involved in the supervision of ILCs since its inception when twenty-nine Morris Plan (industrial) banks were insured by the FDIC on January 1, 1934. However, the modern evolution of ILCs began in 1982 with the passage of the Garn-St Germain Depository Institutions Act. Garn-St Germain expanded ILCs' eligibility to apply for federal deposit insurance, subjecting more ILCs to federal supervision. Shortly

thereafter, in 1987, the Competitive Equality Banking Act (CEBA) clarified which institutions would be subject to the Bank Holding Company Act (BHCA), exempting any company that controls one or more ILCs from the BHCA generally if the ILC received a charter from one of the limited number of states issuing them and the state required federal deposit insurance at that time, as long as one of three conditions are met:<sup>1</sup> (1) the ILC does not accept demand deposits; (2) its total assets are less than \$100 million; or (3) control of the ILC has not been acquired by any company after August 10, 1987. Like other insured institutions, ILCs are subject to examinations and other supervisory activities and generally operate under the same banking and consumer protection requirements, responsibilities, and limitations, as other state chartered banks and savings associations.

The parent companies of ILCs that qualify for the exemption under the BHCA are not required to be supervised by the Federal Reserve or the Office of Thrift Supervision (OTS). Nevertheless, several holding companies supervised by the Federal Reserve or OTS own ILCs.

ILCs comprise a relatively small share of the banking industry—numbering less than one percent of the total 8,790 insured depository institutions and 1.4 percent of the

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<sup>1</sup> CEBA added Section 1841(c)(2)(H) of the BHCA which exempted certain ILCs as follows:  
 “An industrial loan company, industrial bank, or other similar institution which is—  
 (i) an institution organized under the laws of a State which, on March 5, 1987, had in effect or had under consideration in such State’s legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act [12 U.S.C.A. §1811 et seq.]—  
 (I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties;  
 (II) which has total assets of less than \$100,000,000; or  
 (III) the control of which is not acquired by any company after August 10, 1987.”

assets. As of March 31, 2006, there were 61 insured ILCs, with 48 of the 61 operated from Utah and California. ILCs also operate in Colorado, Hawaii, Indiana, Minnesota and Nevada. California, Nevada and Utah are the most active in chartering ILCs. Attachment 1 is a list of all ILCs with their asset and deposit data.

The powers of the ILC charter are determined by the laws of the chartering state. Thus, the authority granted to an ILC may vary from one state to another and may be different from the authority granted to commercial banks. Typically, an ILC may engage in all types of consumer and commercial lending activities and all other activities permissible for insured state banks.

ILCs can generally be grouped according to one of four broadly defined categories. One category includes ILCs that are community-focused. An example of an ILC in this category is Golden Security Bank, a California community bank with \$124 million in assets that was organized in 1982. Institutions in this category often provide credit to consumers and small to medium sized businesses.

A second category includes ILCs that focus on specialty lending programs, including leasing, factoring (i.e., the process of purchasing commercial accounts receivable (invoices) from a business at a discount), and real estate lending. This category includes institutions such as Merrill Lynch Bank USA, which conducts syndicated and bridge financing, asset-based lending, commercial real estate lending and equipment financing, as well as providing standby credit for institutional clients'

commercial paper programs. Merrill Lynch Bank USA currently funds its activities through wholesale deposits and sweep balances from retail brokerage and security accounts. Morgan Stanley Bank, Goldman Sachs Bank USA, UBS Bank USA and Lehman Brothers Commercial Bank also are included in this category.

A third category includes ILCs that are part of financial services units that are, in turn, part of larger corporate organizations that are not necessarily financial in nature. These institutions may serve a particular lending, funding or processing function within the organization. Lending strategies can vary greatly within a specific institution, but are often focused on a limited range of products, such as credit cards, real estate mortgages or commercial loans. Escrow Bank USA, GMAC Automotive Bank and GMAC Commercial Mortgage Bank, all of which are subsidiaries of General Motors,<sup>2</sup> are included in this category, as is General Electric's GE Capital Financial, Inc.

A fourth category includes ILCs that directly support the parent organizations' commercial activities. These institutions largely finance retail purchases of parent company products, ranging from general merchandise to automobiles, corporate purchasing activities, fuel for rental car operations, and home improvements. Loan products include credit cards, lines of credit, and term loans. This category includes institutions such as Toyota Financial Savings Bank and Volkswagen Bank USA, which provide loans to finance the sale of automobiles and for other consumer purposes. The category also includes the \$12 million Target Bank, Utah, which issues proprietary

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<sup>2</sup> General Motors recently sold a majority interest in Escrow Bank USA and GMAC Commercial Mortgage Bank.

commercial credit cards to business customers of Target Stores. Many commercial entities, including Target, also own significant credit card issuing banks as allowed under CEBA.

In addition to retail deposits, such as NOW and savings accounts, funding sources for the ILCs in these various categories may include wholesale deposits, money center operations and borrowings. Institutions that operate within a larger corporate organization may also obtain funding through the parent organization in the form of deposits, borrowings or equity. In some cases, corporate strategies may play a large role in determining funding strategies.

#### **ILC Profile**

The ILC charter has generated a significant amount of public interest in recent years as various entities have explored the feasibility and business opportunities of including an ILC as part of their operations. While it is not possible to predict the future course of the ILC charter, it is useful to examine the profile of the 61 existing ILCs. ILCs are owned by a diverse group of financial and commercial firms. Of the 61 existing ILCs, 43 are either independently owned or affiliated with a parent company whose business is primarily financial in nature. These include ILCs owned by such companies as Merrill Lynch, American Express and Morgan Stanley. These 43 ILCs comprise approximately 90 percent of the ILC industry's assets and deposits. The remaining 18 ILCs are associated with parent companies that can be considered non-financial. They

account for approximately ten percent of ILC assets and deposits. In particular, it is important to emphasize that while the ILC industry has grown significantly in recent years, this growth has overwhelmingly occurred in ILCs with financial parent organizations. ILCs with commercial parent organizations represent a very small proportion of ILC asset growth.

Table 1 lists the top five ILCs which each hold more than \$10 billion in assets, accounting for approximately 76 percent of all ILC assets and 81 percent of all ILC deposits. Of these five ILCs, four are affiliated with financial services firms; the fifth has existed since 1937 and has grown through commercial real estate lending and the origination and sale of mortgages. The largest ILC (Merrill Lynch Bank USA) alone holds approximately 40 percent of ILC assets and 49 percent of ILC deposits.

<b>Table 1</b>		
<b>Top Five Industrial Loan Corporations by Asset Size</b>		
<b>Institution</b>	<b>Total Assets (in millions)</b>	<b>Total Deposits (in millions)</b>
MERRILL LYNCH BANK USA	62,040.4	54,160.1
UBS BANK USA	18,998.6	16,415.7
AMERICAN EXPRESS CENTURION BANK	13,779.7	2,725.8
FREMONT INVESTMENT & LOAN	12,856.5	9,297.1
MORGAN STANLEY BANK	10,884.9	7,702.5
Source: FDIC Call Report Data, March 31, 2006		

By contrast, 39 ILCs, including 11 affiliated with non-financial firms, have less than \$500 million in assets. These 39 ILCs account for approximately three percent of ILC industry assets and deposits.

Among the ILCs associated with firms that can be considered non-financial, GMAC Commercial Mortgage Bank has been the largest, holding just under \$4 billion in assets and accounting for 2.6 percent of ILC industry assets and 2.9 percent of ILC industry deposits.<sup>3</sup> Ten of the 18 ILCs that are owned by non-financial firms conduct permissible banking activities that directly facilitate their parent organization's distinctly commercial activities. For instance, Target Bank issues credit cards to commercial entities to facilitate purchases from Target Stores. The remaining eight institutions also conduct permissible banking activities. However, these activities are conducted within the financial services units of larger commercial organizations.

Between 1987 and 1995, the assets in ILCs grew from \$4.2 billion to \$11.5 billion. In 1996, American Express moved its credit-card operations from its Delaware credit card bank to its Utah ILC, increasing the assets in the industry to \$22.6 billion by year end. Beginning in 1999, Merrill Lynch changed the default option for its brokerage's customers which resulted in moving their cash management accounts to insured deposits in its ILC. This action led to insured deposit growth of approximately \$3 billion in 1999 and \$37 billion in 2000. Since 2000, at least three additional financial services firms associated with ILCs—UBS, Lehman Brothers and Morgan Stanley—have

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<sup>3</sup> General Motors recently sold a majority interest in Escrow Bank USA and GMAC Commercial Mortgage Bank.

offered their clients the option of holding their cash funds in insured deposits that are placed in the financial services firms' ILCs through deposit sweep programs.

Today, the assets in ILCs are approximately \$155 billion. This reflects growth from \$4.2 billion in 1987. ILCs owned by the four financial services firms cited above accounted for 63 percent of this growth. See Attachment 2. Excluding these four ILCs, all other ILCs grew by approximately \$56 billion over the period 1987 through the first quarter of 2006. Overall, the ILCs' share of insured-institution assets is 1.4 percent.

With regard to the portfolios of ILCs, 71 percent of ILC assets are in loans and leases, compared to 61 percent for insured institutions. Within this category, ILCs predominately hold commercial and industrial loans (27 percent), credit card loans (18 percent), other consumer loans (14 percent) and 1-4 family mortgages (13 percent). Attachment 3 provides greater detail on ILC industry asset composition, although concentrations within individual institutions will vary from the aggregate numbers.

ILCs have a good safety and soundness track record to date. Overall, the FDIC's examination experience with ILCs has been similar to the larger population of insured institutions, and the causes and patterns displayed by problem ILCs have been like those of other institutions. As noted in the Government Accountability Office's 2005 report on ILCs, "from an operations standpoint [ILCs] do not appear to have a greater risk of failure than other types of depository institutions." The authorities available to the FDIC to supervise ILCs have proven to be adequate thus far for the size and types of ILCs that

currently exist. Recognizing the dynamic nature of the ILC industry, however, the FDIC is examining whether additional authorities could prove useful in ensuring the safety and soundness of these institutions.

### **Supervision**

ILCs are supervised by the FDIC in the same manner as other state nonmember banks. They are subject to regular examinations, including examinations focusing on safety and soundness, consumer protection, community reinvestment, information technology and trust activities. ILCs are subject to FDIC Rules and Regulations, including Part 325, pertaining to capital standards, and Part 364, pertaining to safe-and-sound standards of operation. In addition, ILCs are subject to restrictions under the Federal Reserve Act governing transactions with affiliates and tying practices, as well as consumer protection regulations and the Community Reinvestment Act. Just as for all other insured banks, ILC management is held accountable for ensuring that all bank operations and business functions are performed in a safe and sound manner and in compliance with federal and state banking laws and regulations. Four of the largest and most complex ILCs are subject to near continuous on-site supervision.

The primary difference in the supervisory structures of the ILCs and other insured financial institutions is the type of authority over the parent organization. The Federal Reserve and the OTS have explicit supervisory authority over bank and thrift holding companies, including some holding companies that currently own ILCs. The FDIC has

the authority to examine affiliate relationships with the ILC, including its parent company and any other third party, as may be necessary to determine the relationship between the ILC and the affiliate, and to determine the effect of such relationship on the ILC. In the case of a parent company subject to the reporting requirement of another regulatory body covered under the Gramm-Leach-Bliley Act of 1999, such as the Securities and Exchange Commission or a state insurance commissioner, the FDIC and the functional regulator share information.

FDIC supervisory policies regarding any institution owned by a parent organization, including ILCs, are concerned with organizational relationships, particularly regarding compliance with the rules and regulations intended to prevent potentially abusive practices. The scope and depth of review vary depending upon the nature and extent of intercompany relationships and the degree of risk posed to the institution.

An examination would typically include a review of the ILC's strategies and processes, compliance with the conditions of its deposit insurance order, interdependencies and corporate separateness, management competencies, risk management programs, financial condition and performance, and prospects. Examination procedures include an assessment of the ILC's parent's corporate structure and how the ILC interacts with its affiliates, as well as an evaluation of any risks that may be inherent in the relationship. Transaction testing assesses compliance with sections 23A and 23B of the Federal Reserve Act, which places limits on the quantity and quality of such

transactions, and the propriety of the transactions. In addition to assessing purchase and sale transactions involving the institution and its affiliates, all services provided to or purchased from an affiliate must be on the same terms and conditions as with non-affiliated entities. All services relationships must be governed by a written agreement and the ILC should have a contingency plan for all critical business functions performed by affiliated companies. Transaction testing also encompasses transactions with insiders and their related interests. Such transactions are governed by the Federal Reserve Board's Regulation O, which governs credits to insiders and their related interests.

Examiners also review any arrangements involving shared management or employees. Agreements between the ILC and its affiliate are expected to be in place that define compensation arrangements, specify how to avoid conflicts of interest, establish reporting lines, and assign authority for managing the shared employee relationships.

#### *Enforcement Authority*

As discussed earlier, the FDI Act provides that the FDIC can examine the affairs of any affiliate of an ILC (including the parent) as may be necessary to disclose fully the relationship between such ILC and any affiliate; and the effect of such relationship on the ILC. The FDIC also possesses authority to restrict or prohibit a supervised bank from engaging in activities with an affiliate or any third party that may cause harm to the insured institution.

As with all FDIC-supervised institutions, Section 8(b) of the FDI Act includes the authority to place limitations on the activities or functions of an institution or institution affiliated parties, including a parent company or non-bank subsidiary (unless the parent is a bank holding company supervised by the Federal Reserve). This includes the authority to require such party to, among other actions, make restitution or provide reimbursement, indemnification, or guarantee against loss; dispose of any asset involved; rescind agreements or contracts; or take such other action as the agency determines to be appropriate. In an appropriate circumstance, divestiture is available as an affirmative remedy to a parent organization's unsafe or unsound practices. The FDIC would also have options to impose civil money penalties.

As with all FDIC-supervised institutions, Section 38 of the FDI Act (Prompt Corrective Action or PCA) gives the FDIC the authority under certain circumstances to obtain guarantees of capital plans from the ILC's parent company. Under PCA, if an ILC is significantly undercapitalized, and fails to file an acceptable plan, or fails to implement an approved capital plan, the FDIC must apply safeguards that could include a requirement that a parent company or other controlling party divest itself of the institution if the agency determines that divestiture would improve the institution's condition and prospects.

The FDIC also has the authority to enforce conditions or written agreements that apply to ILCs and their parent organization. Section 8 of the FDI Act provides various predicates for enforcement, including a "violation of a condition." Where there is a

breach of a condition or written agreement, no additional findings are required to justify the enforcement action, and the breach can be pursued without consideration of its safety and soundness or other consequences.

### **Application for Deposit Insurance and Notice of Change in Bank Control**

The FDIC generally follows the same review process for applications for deposit insurance and notices of changes in bank control relative to ILCs as it does for such requests from other applicants.

#### *Application for Deposit Insurance*

The review and investigation of chartering and deposit insurance applications for new institutions are coordinated between the FDIC and the applicable state chartering agency. The processing of applications is performed in accordance with Sections 5 and 6 of the FDI Act, sections 303.20-25 (Deposit Insurance) of the FDIC Rules and Regulations, and the FDIC Statement of Policy on Applications for Deposit Insurance. All applicants for FDIC insurance must satisfactorily address seven statutory factors enumerated in Section 6 of the FDI Act, as follows:

1. The financial history and condition of the institution.
2. The adequacy of the institution's capital structure.
3. The future earnings prospects of the institution.
4. The general character and fitness of the management of the institution.

5. The risk presented by the institution to the deposit insurance fund.
6. The convenience and needs of the community to be served by the institution.
7. The consistency of the institution's corporate powers with the purposes of the FDI Act.

In addition, the FDIC must evaluate the application to determine compliance with any applicable requirements of the Community Reinvestment Act, the National Environmental Protection Act and the National Historic Preservation Act.

*Notice of Change in Bank Control*

The processing of a notice for a change in control is performed in accordance with Section 7 of the FDI Act and sections 303.80-86 (Change in Bank Control) of the FDIC Rules and Regulations. Notificants must satisfactorily address the statutory factors enumerated in Section 7 of the FDI Act, which generally provide that the appropriate federal banking agency may disapprove any proposed acquisition if:

1. the proposed acquisition of control would result in a monopoly;
2. the proposed acquisition of control would substantially lessen competition in any section of the country or tend to create a monopoly, or would in any other manner constitute a restraint of trade which is not outweighed by the convenience and needs of the community;
3. the financial condition of the acquiring party might jeopardize the bank or prejudice depositors;
4. the competence, experience or integrity of any acquiring person or proposed management indicates that the acquisition would not be in the best interest of depositors or the public;
5. any acquiring party neglects, fails, or refuses to furnish information required by the appropriate federal regulator; or

6. the acquisition would have an adverse effect on the Deposit Insurance Fund.

#### *Processing*

Filers of either an application for deposit insurance or a notice of a change in bank control are encouraged to meet with supervisory staff prior to submitting a filing in order to identify potential significant issues or address material deficiencies in the proposal. Upon submission of a substantially complete filing, the FDIC, together with the chartering state, may initiate a field investigation, during which examiners review all aspects of the given proposal. Central to the FDIC's review of the filing is a well-defined, comprehensive and supported business plan. Ultimately, examiners will assess the proposal in light of the statutory factors and prudent banking practices, and will develop a recommendation relative to each statutory factor.

#### *Conditions*

In the case of applications for deposit insurance, the FDIC has the authority to impose reasonable conditions through its order approving the application. Decisions regarding specific conditions to be imposed are based upon the totality of the application and investigation, and may consider such issues as the complexity and perceived risk of the proposed business plan, adequacy of capital and management, relationships with affiliated entities, and sufficiency of risk management programs, among other considerations. Some conditions must be satisfied before deposit insurance becomes

effective. Other conditions or limitations may be time-specific and some may impose continuing requirements or restrictions that must be satisfied on an ongoing basis, even beyond an institution's initial years of operation. Conditions that impose ongoing requirements remain in effect as long as the FDIC determines that the condition is necessary to ensure the safe-and-sound operation of the institution. The FDIC can also require written agreements with the institution and its parent that address capital maintenance, liquidity and other matters as appropriate.

In the cases involving a change in bank control, the FDIC can impose requirements and restrictions through a formal agreement among the FDIC, the institution and the parent company. Provisions of the formal agreement can be substantially similar to those imposed on a newly organized institution and its parent.

#### *Delegations of Authority*

While approval authority for many applications and notices has been delegated by the FDIC Board of Directors to regional management, the delegations are limited in the case of institutions to be operated under parent organizations not subject to the Bank Holding Company Act. In these cases, approval authority has been delegated only to the Washington Office management. Further, the FDIC Board of Directors retains approval authority in those cases in which the underlying proposal does not conform to FDIC policy. All recommendations to deny an application for deposit insurance also are presented to the FDIC Board of Directors. However, proposals that fail to satisfy the

required statutory factors and regulatory concerns are usually withdrawn by the filers before being denied by the FDIC or the respective state chartering authorities.

This concludes my statement. The FDIC appreciates the opportunity to testify regarding the profile and supervision of ILCs. I will be happy to answer any questions that the Subcommittee might have.

## Attachment 1

Industrial Loan Companies (Financial Data as of March 31, 2006, in millions)					
Insured	Institution	Total Assets	Total Deposits	State	Parent
10/31/1988	MERRILL LYNCH BANK USA	62,040.4	54,160.1	UT	Merrill Lynch
9/15/2003	UBS BANK USA	18,998.6	16,415.7	UT	UBS AG
3/20/1989	AMERICAN EXPRESS CENTURION BANK	13,779.7	2,725.8	UT	American Express
9/24/1984	FREMONT INVESTMENT & LOAN	12,856.5	9,297.1	CA	Fremont General Corporation
5/25/1990	MORGAN STANLEY BANK	10,884.9	7,702.5	UT	Morgan Stanley
9/27/1996	USAA SAVINGS BANK	6,851.6	256.4	NV	USAA Life Company
4/1/2003	GMAC COMMERCIAL MORTGAGE BANK	3,991.4	3,220.0	UT	GMACCH Invest / GMAC
8/24/05	LEHMAN BRO. COMMERCIAL BANK	3,338.2	2,899.9	UT	Lehman Brothers Bank FSB
8/2/2004	GMAC AUTOMOTIVE BANK	3,060.6	2,573.1	UT	GMAC (General Motors)
8/2/2004	BEAL SAVINGS BANK	2,245.6	153.9	NV	Beal Financial Corporation
11/12/1999	BMW BANK OF NORTH AMERICA	1,863.4	1,511.9	UT	BMW Group
2/12/1993	GE CAPITAL FINANCIAL INC	1,812.0	246.6	UT	GE (General Electric)
12/16/1991	ADVANTA BANK CORP	1,552.8	1,065.9	UT	Advanta
10/5/1984	FIRESIDE BANK	1,310.7	1,084.9	CA	Unitrin, Inc.
10/20/2000	CIT BANK	933.7	693.4	UT	CIT Group
9/22/1997	MERRICK BANK	736.2	551.8	UT	CardWorks, LP
6/1/1998	WRIGHT EXPRESS FINL SERVICES	694.5	524.3	UT	Wright Express
11/3/1989	CENTENNIAL BANK	691.0	555.3	CA	Land America Financial Group
1/10/2002	VOLKSWAGEN BANK USA	684.8	546.6	UT	Volkswagen
6/4/1984	FINANCE FACTORS, LTD	655.6	499.1	HI	Finance Enterprises
1/16/1998	PITNEY BOWES BANK INC	553.0	470.0	UT	Pitney Bowes
9/12/1985	UNIVERSAL FINANCIAL CORP	535.2	376.1	UT	Citigroup
8/29/1991	TAMALPAIS BANK	469.1	326.5	CA	No affiliation
8/26/1988	SILVERGATE BANK	412.4	180.5	CA	Silvergate Capital
11/12/1999	REPUBLIC BANK INC	357.9	285.9	UT	No affiliation
10/1/1998	TRANSPORTATION ALLIANCE BK	334.7	278.4	UT	Flying J, Inc.
9/10/1985	COMMUNITY COMMERCE BANK	296.4	206.2	CA	TELACU
12/22/2003	MEDALLION BANK	259.0	215.0	UT	Medallion Financial
4/3/2000	SECURITY STATE SAVINGS BANK	222.4	118.4	NV	Stampede Capital LLC
9/22/2004	INDEPENDENCE BANK	205.5	136.2	CA	Independence Financial Services
11/5/1985	5 STAR BANK	201.6	144.6	CO	Armed Forces Benefit Association
12/1/2003	WORLD FINANCIAL CAPITAL BANK	196.3	131.2	UT	Alliance Data Systems
6/3/1985	HOME BANK OF CALIFORNIA	173.5	130.7	CA	La Jolla Savers and Mortgage Fund
1/22/1990	CIRCLE BANK	173.4	133.7	CA	No affiliation
7/3/1986	BALBOA THRIFT & LOAN ASSN	152.3	136.0	CA	No affiliation
7/21/2003	EXANTE BANK	140.9	85.6	UT	UnitedHealth Group
9/29/05	MAGNET BANK	137.6	78.8	UT	Unaffiliated
6/28/1989	FIRST SECURITY THRIFT CO	137.2	83.8	CA	First American Financial
7/21/1987	FIRST FINANCIAL BANK	137.0	26.8	CO	First Data Corp.
2/25/1986	GOLDEN SECURITY BANK	124.2	101.4	CA	No affiliation
12/17/1984	FINANCE & THRIFT CO	113.6	114.6	CA	F&T Financial Services, Inc.
11/28/05	SALLIE MAE BANK	102.5	1.0	UT	Sallie Mae
12/17/1984	RANCHO SANTA FE TH & L ASSN	99.4	69.8	CA	First Trust Savings Bank
6/3/2002	ENERBANK	91.3	77.7	UT	CMS Energy
3/1/2001	CELTIC BANK	74.0	64.0	UT	Celtic Investment, Inc.
3/23/1990	THE MORRIS PLAN COMPANY	61.9	46.7	IN	First Financial Corporation
9/28/1987	HOME LOAN INDUSTRIAL BANK	54.9	44.0	CO	Home Loan Investment Company
8/16/2004	TOYOTA FINANCIAL SAVINGS BANK	53.9	15.1	NV	Toyota
2/16/1990	TUSTIN COMMUNITY BANK	48.4	36.9	CA	No affiliation
11/3/1999	ESCROW BANK USA	39.4	0.8	UT	GMACCH Invest / GMAC

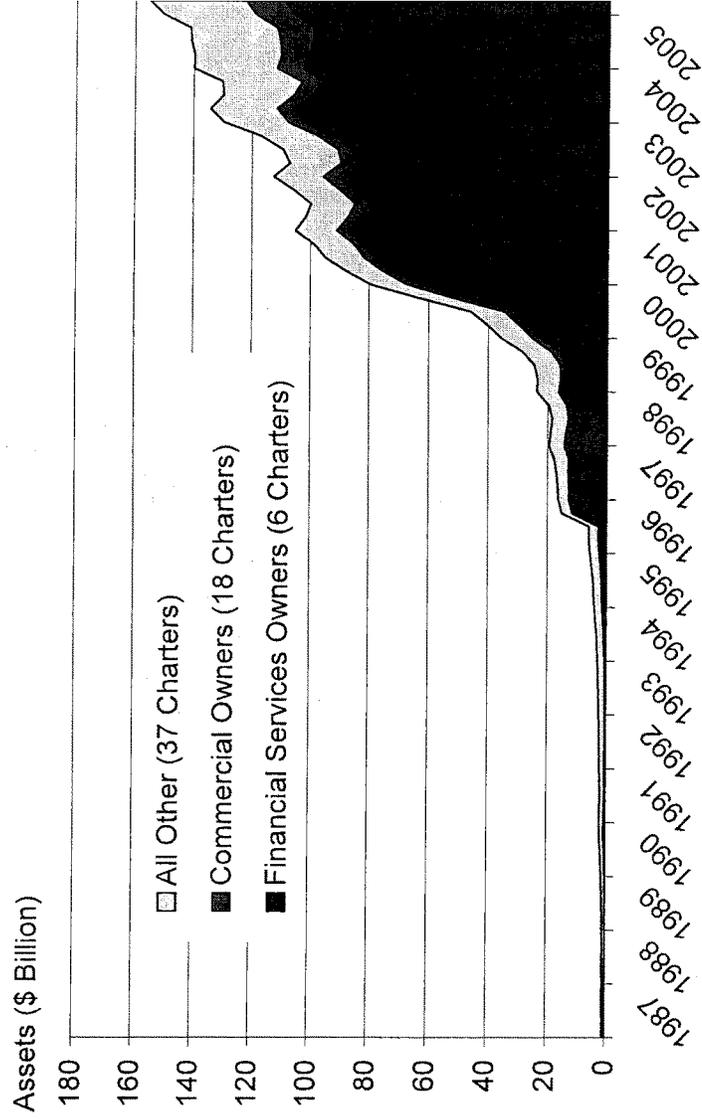
Industrial Loan Companies (Continued)					
Insured	Institution	Assets	Deposits	State	Parent
8/25/1997	EACLEMARK SAVINGS BANK	32.2	3.6	NV	Harley-Davidson
8/1/05	ALLEGIANCE DIRECT BANK	26.1	20.1	UT	Leavitt Group Enterprises, Inc.
8/7/1986	MINNESOTA 1ST CREDIT & SVG INC	25.0	18.1	MN	Minnesota Thrift Company
7/6/2004	GOLDMAN SACHS BANK USA	22.0	0.5	UT	Goldman Sachs
10/5/2000	FIRST ELECTRONIC BANK	13.6	9.2	UT	Fry's Electronics
9/27/2004	TARGET BANK	12.3	5.4	UT	Target Corporation
5/15/1997	WEBBANK	6.6	1.0	UT	Steel Partners II, LP
1/26/06	LCA BANK CORPORATION	5.4	0.2	UT	Lease Corporation of America
9/22/1997	AMERICAN SAVINGS INC	3.7	0.9	MN	Waseca Bancshares
5/1/2000	VOLVO COML CREDIT CORP OF UT	2.8	0.5	UT	Volvo
1/12/2001	TRUST INDUSTRIAL BANK	2.7	0.5	CO	FISERV
		155,093.5	110,860.7		

Pending Applications for Deposit Insurance					
Insured	Institution	Assets	Deposits	State	Parent
NA	COMDAT A BANK	NA	NA	UT	Ceridian Corporation
NA	DAIMLERCHRYSLER BANK US	NA	NA	UT	DaimlerChrysler
NA	CAPITALSOURCE BANK	NA	NA	UT	CapitalSource, Inc.
NA	WAL-MART BANK	NA	NA	UT	Wal-Mart
NA	MARLIN BUSINESS BANK	NA	NA	UT	Marlin Business Services, Corp.
NA	AMERICAN PIONEER	NA	NA	UT	City Financial
NA	HEALTHCARE BANK	NA	NA	UT	Blue Cross/Blue Shield
NA	BERKSHIRE HATHAWAY BANK	NA	NA	UT	Berkshire Hathaway
NA	FIFTH STREET BANK	NA	NA	NV	Security National Master Holding Company

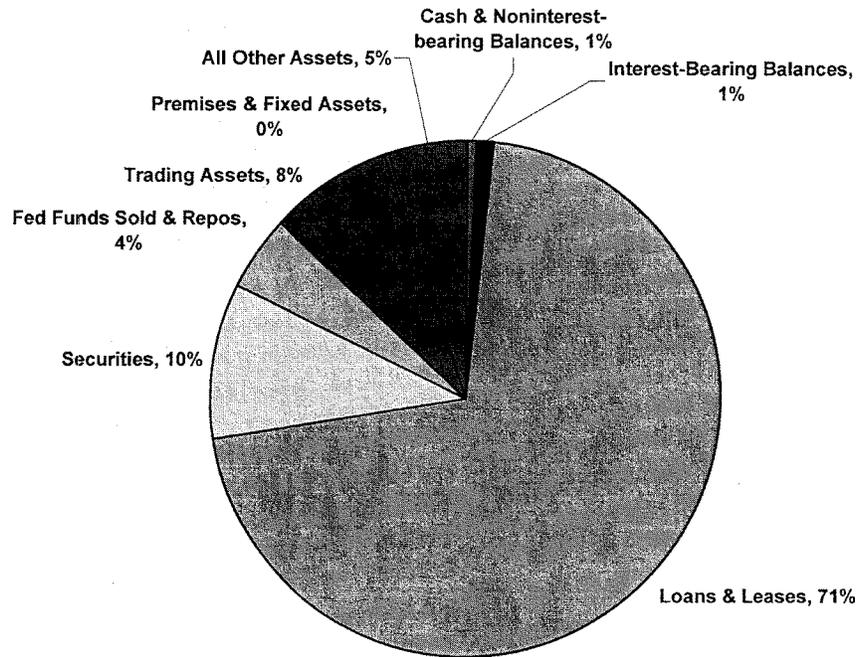
Pending Notices of Change in Bank Control					
Insured	Target Institution	Assets	Deposits	State	Acquiring Entity
8/2/2004	GMAC AUTOMOTIVE BANK	3,060.6	2,573.1	UT	Cerberus
9/22/1997	MERRICK BANK	736.2	551.8	UT	Compu-Credit
8/26/1988	SILVERGATE BANK	412.4	180.5	CA	WESCOM Credit Union
6/3/2002	ENERBANK	91.3	77.7	UT	The Home Depot
5/1/2000	VOLVO COML CREDIT CORP OF UT AH	2.8	0.5	UT	NHB Holdings, Inc.

Attachment 2

**ASSETS OF 61 FDIC-INSURED ILCs, 1986 - 2006**



**ASSET PORTFOLIO OF 61 FDIC-INSURED ILCs  
March 31, 2006**





Testimony  
by  
Terry Jorde  
President/CEO  
CountryBank USA  
Cando, ND  
&  
Chairman  
Independent Community Bankers of America  
Washington, DC

**“Industrial Loan Charters”**

United States House of Representatives  
Committee on Financial Services  
Subcommittee on Financial Institutions and Consumer  
Credit

July 12, 2006

Mr. Chairman, Ranking member Sanders and members of the subcommittee, my name is Terry Jorde, President and CEO of CountryBank USA. I am also Chairman of the Independent Community Bankers of America.<sup>1</sup> My bank is located in Cando, North Dakota, a town of 1,300 people where the motto is, "You Can Do Better in Cando." CountryBank has 29 full time employees and \$39 million in assets. ICBA is pleased to have this opportunity to testify today on the industrial loan company charter.

The ILC specter looms over the nation's financial system. The flood of new applications for ILC charters threatens to eliminate the historic separation of banking and commerce and undermine the system of holding company supervision, harming consumers and threatening financial stability.

Both Federal Reserve Chairman Ben Bernanke and former Chairman Alan Greenspan agree that Congress must address this issue. Chairman Bernanke recently responded to a written question from a member of this committee:

The question of whether, or to what extent, the mixing of banking and commerce should be permitted is an important issue and one that, we believe, should be made by Congress.<sup>2</sup>

In one of his final letters as Chairman, Greenspan wrote:

The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption. These changes are undermining the prudential framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision. These are crucial decisions that should be made in the public interest after full deliberation by the Congress; they should not be made through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of states.<sup>3</sup>

We urge the Congress as strongly as we can to accept this advice and to block the applications by commercial firms and to strengthen the regulation and supervision of the ILCs.

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<sup>1</sup> The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).

<sup>2</sup> Letter to Rep. Brad Sherman, March 21, 2006.

<sup>3</sup> Letter to Rep. Jim Leach, January 20, 2006, (Greenspan letter to Leach)

Each time Congress has been confronted with loopholes like the one the Committee is addressing today it has reaffirmed the separation of banking and commerce and the importance of holding company supervision. Congress closed the unitary thrift holding company loophole in 1999 and closed the non-bank bank loophole in 1987. It is now time to close the ILC loophole.

#### **Action is Urgent**

A record number of ILC applications are pending before the FDIC. Applicants include nationwide retailers (Wal-Mart and Home Depot); auto companies (Ford and Volvo); investment giant, Berkshire Hathaway; the Blue Cross/Blue Shield Association; and even credit unions (Wescom and a separate consortium). Even before these latest applications, the ILC industry has grown rapidly and it has come to dominate the banking industry in the State of Utah.

Congress never intended this result. In recent testimony before the FDIC, former Senator and Banking Committee Chairman Jake Garn (R-Utah) discussed the Competitive Equality Banking Act of 1987 (CEBA) that permitted certain states to continue to charter ILCs that are exempt from the Bank Holding Company Act. He told the FDIC that, "it was never my intent, as the author of this particular section, that any of these industrial banks be involved in retail operations." In fact, it was in CEBA that Congress closed the nonbank bank loophole. It certainly would have been inconsistent had Congress closed that loophole while intending to leave a similar one wide open.

In his letter earlier this year, then Federal Reserve Chairman Greenspan noted that there is little legislative history explaining why Congress did not close the ILC loophole in 1987. He suggested that, "This may be because in 1987 ILCs generally were small, locally owned institutions that had only limited deposit-taking and lending powers under state law....Moreover, in 1987, the relevant states were not actively chartering new ILCs. Utah, for example, had a moratorium on the chartering of new ILCs at the time CEBA was enacted."<sup>5</sup>

Unfortunately, the ILC provision in CEBA has become a loophole that is as dangerous as the ones that Congress closed in 1987 and 1999. Chairman Greenspan noted that, "The landscape related to ILCs has changed significantly since 1987....In 1997, for example, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves 'banks,' and permitted ILCs to exercise virtually all of the powers of state-chartered commercial banks. In addition, Utah and certain other grandfathered states have since begun actively to charter new ILCs and promote ILCs as a method for companies to acquire a bank while avoiding the requirements of the BHC Act."<sup>6</sup> Greenspan added, "The total assets held by ILCs have grown by more than 3,500 percent between 1987

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<sup>4</sup> Ford recently withdrew its application for technical reasons, but has said it plans to refile.

<sup>5</sup> Greenspan letter to Leach.

<sup>6</sup> Id.

and 2004, and the aggregate amount of estimated insured deposits has increased by more than 500 percent just since 1999.<sup>7</sup>

As a result of this greatly increased activity, a charter that has existed for around 100 years in just a few states threatens to propel that charter and just those few states into dominance of the nation's financial system. As Chairman Greenspan pointed out, "while only a handful of states have the ability to charter exempt ILCs, there is no limit on the number of exempt ILCs these grandfathered states may charter in the future."<sup>8</sup> (emphasis in original)

### **Policy Reasons Why Congress Should Close the ILC Loophole**

This rapid ILC growth gives greater urgency to the compelling policy reasons for Congress to close the ILC loophole, just as it closed the nonbank bank and unitary thrift holding company loopholes.

#### ***Threatens Safety and Soundness***

In 1999, Congress decided that the nation's regulatory system had evolved to the point that it was appropriate for various types of financial firms to affiliate within a single company. While we had serious misgivings about this policy, ICBA strongly supported Congress's decision to clearly exclude commercial firms from these financial holding companies, close the unitary thrift holding company loophole, and require that companies that own banks be subject to consolidated supervision.

Bankers who have provided billions of dollars to capitalize the Deposit Insurance Funds have a strong interest in maintaining its strength. Granting federally insured ILCs to the nation's commercial firms adds tremendous new risks to the DIF. One of the newest applicants for an ILC charter is the Ford Motor Company. This is what the Chicago Tribune reported about Ford on June 29:

Standard & Poor's Ratings Services said it has lowered its corporate credit rating on Ford Motor Co. further into "junk" status, saying that 2006 will be a more difficult year for the nation's second-largest automaker than previously expected. "Notwithstanding its multiyear plan to turn around the performance of its North American automotive operations, we expect the company's financial profile to weaken further during 2006," said S&P credit analyst Robert Schulz. S&P lowered Ford's corporate credit rating to B-plus from BB-minus.

As a result, banking regulators will not allow banks to buy Ford bonds. Ford hardly sounds like a "source of strength" for an FDIC-insured ILC.

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<sup>7</sup> Id.

<sup>8</sup> Id.

Ford's problems can be traced to major changes in the structure of the automotive industry. Other ILC applicants are also potentially vulnerable to changes in their own markets. Wal-Mart faces risks that other banks, and even other commercial firms, do not face. For example, since 70% of the products sold in Wal-Mart stores are produced in China, Wal-Mart faces financial risks due to currency fluctuations and the volatile transportation and fuels market. Wal-Mart has become China's most important trading partner, and if Wal-Mart were a country, it would rank as China's eighth largest trading partner, ahead of Russia, Australia and Canada. Notably, Wal-Mart's business model looks to expand its retail operation in China to surpass even its mammoth U.S. operations. Wal-Mart's systemic risk to the financial and payment system is likewise expanded globally to encompass the actions of other countries and political, currency and monetary systems.

Home Depot is the world's largest home improvement specialty retailer and the second largest retailer in the United States, operating more than 2,000 stores across North America and processing more than 1.33 billion customer transactions per year. While profitable today, with 2005 earnings of \$5.8 billion, the specialized nature of Home Depot and its ILC acquisition target EnerBank, make them susceptible to fluctuations in the general economy, real estate sales, and specifically the home improvement market. Because Home Depot is susceptible to sudden changes in economic conditions, it may not always be a reliable source of strength for EnerBank. EnerBank is itself vulnerable, since its "only business is funding fixed-rate, unsecured, close-end, direct consumer installment loans for a broad range of home improvement projects"<sup>9</sup> (emphasis added)

Sudden changes in the home improvement market could send both Home Depot and EnerBank spiraling into a meltdown. EnerBank's lending portfolio will not be diversified enough to protect against such market volatility. This poses a severe and unacceptable risk to the Deposit Insurance Fund.

This brief discussion of the actual and potential difficulties of ILC applicants illustrates a key policy reason to maintain the separation of banking and commerce. Financial services regulators – no matter how competent – do not have the expertise to understand each of these potential micro-economic areas and protect the safety and soundness of the ILC from problems that befall the overall enterprise. Furthermore, Congress should be concerned about the possibility that a financial regulator might find it necessary to become involved in market decisions of a major commercial firm. That is where we are headed unless Congress deals with this loophole.

Imagine if Enron or WorldCom had owned an ILC. Their problems could have easily spilled over to their banks, draining the FDIC's resources and requiring all banks – including community banks – to cover the costs.

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<sup>9</sup> The Home Depot, Inc. Interagency Notice of Change in Control – Public, May 8, 2006, page 8.

***Jeopardizes the Payments System***

The Wal-Mart application highlights another area of risk posed by the ILC loophole: risks to the objectivity and security of the payments system. Wal-Mart has said that its business plan for the ILC is narrowly drawn to provide back office processing of credit card, debit card and electronic check transactions in Wal-Mart stores. However, even this seemingly narrow range of activity could have far-reaching and detrimental effects. A Wal-Mart bank would provide Wal-Mart with the capability to exert undue influence on the payments system through its suppliers to the detriment of other participants. A Wal-Mart bank would pose significant systemic settlement and security risks to the payments system and its participants given Wal-Mart's dominant role in the global economy.

Banks play a central role in the payments system. The Wal-Mart Bank proposes to process the hundreds of millions of payments customers make in Wal-Mart stores. These customers pay with checks and cards issued by just about every bank in the country. Currently, fully regulated banks do this work for Wal-Mart.

While companies other than banks may help stores and banks process check and card transactions, only banks can actually transfer funds from one party to another, known as settlement. Federal supervisors make sure that banks follow stringent policies and procedures to manage the risks involved in clearing and settling payments transactions and have adequate capital. These risks include fraud and potential insolvency of those who are making and accepting payments, and those who are clearing and settling them.

***Market Dominance, Systemic Risk***

Given Wal-Mart's retail dominance, the Wal-Mart Bank would quickly become a major participant in the global payments system. Wal-Mart stores accept 140 million electronic transactions a month. The Wal-Mart Bank would process over \$170 billion per year. This does not include the transfer of funds to Wal-Mart suppliers.

The Wal-Mart Bank would have to balance its responsibilities as a federally-insured bank with the liquidity, profitability and business demands of its owner. Wal-Mart, the holding company, could insist that the Wal-Mart Bank delay payments or take other actions that add new risks to the payments system. The Wal-Mart Bank's failure to timely settle payment transactions could harm thousands of other financial institutions and their customers. Since the owners of ILCs are exempt from Federal Reserve oversight, there is weakened regulatory protection to effectively guard against this abuse.

***Capital Adequacy***

The scope and potential expansion of Wal-Mart's payments system operations raises questions about the level of capital that it should be required to hold to guard against loss. Wal-Mart Bank's asset size, which its application projects to be less than \$30 million during the first three years of operation, will mask the true risk posed by the bank. Large scale operational and settlement risk flowing

from its hundreds of billions of payments each year will be the main concern, not credit risk represented on its balance sheet. In fact, the bank will clear twenty times or more the dollar value of its assets in payments transactions each day just from the Wal-Mart stores.

#### ***Payments System Powerhouse***

Once the Wal-Mart Bank establishes its hold in the payments system, it could easily expand by offering its payments clearing services to other businesses of all sizes, increasing its role in the payments system and increasing concentration and risk. Wal-Mart's subsidiary, Sam's Clubs, already offers a myriad of products to small- and medium-size businesses. Sam's Clubs could easily offer its customers payment services from the Wal-Mart Bank.

Particularly troubling, Wal-Mart could use its extraordinary market clout to require that its suppliers use its banking services as a condition of doing business with Wal-Mart. Wal-Mart has a well-established, heavy-handed reputation for dealing with its suppliers. Wal-Mart has the clout to demand that a company as large and powerful as Coca Cola change its century old distribution system of having local bottlers deliver product to Wal-Mart stores. Wal-Mart insisted that Coke move to a straight-to-warehouse method. Basically, it's the Wal-Mart way or no way. If a business sells a significant percentage of its products to Wal-Mart, as many suppliers do, it would have little choice but to bank with Wal-Mart.

Once established, the Wal-Mart Bank would also be ideally positioned to exert undue influence on other banks, payments networks and payments processors to obtain the lowest pricing possible and to create rules to its advantage. Moreover, given its sheer dominance, the Wal-Mart Bank could decide to game payments rules it did not like. This could damage other stakeholders and upset the equilibrium of the payments system. Without effective regulation and supervision of Wal-Mart, the judicial system is the only recourse for addressing this undue influence. Wal-Mart has the financial resources to delay any litigation to the point where the harmed entities would no longer be in business.

Finally, a Wal-Mart bank would signal a paradigm shift in the payments industry. To stay competitive, other retailers would have to follow suit. In a retailer-driven payments environment, seeking competitive advantage, rather than risk mitigation, would be the driving force. Consumers, small businesses, and banks of all sizes would be the victims if risk mitigation policies become secondary to market share.

#### ***Presents Serious Conflicts of Interest***

The Home Depot application highlights yet another reason to maintain the separation of banking and commerce. It is apparent even from the limited information available that the arrangement would blur commercial and banking activities and lead to customer confusion.

Even though Home Depot provides assurances in its notice that EnerBank loans will not be tied to purchases from its stores, the business plan outlined in the notice blurs the line between its lending and commercial activities. The notice states: "EnerBank has had significant success helping local, small contractors achieve business success. This fits with The Home Depot's desire to expand its relationships with contractors and trade professionals – especially the local, small contractors that are core to The Home Depot's business."<sup>10</sup>

The notice also states that, "EnerBank services will be introduced to The Home Depot's very large commercial customer base – which includes potentially hundreds of thousands of home improvement and remodeling contractors that EnerBank can partner with. The Home Depot would also support EnerBank's growth with its current partner sponsors and contractors."<sup>11</sup>

From the information available in the public portion of this notice, it is unclear exactly how the relationship among Home Depot, its contractor customers, home improvement customers, and EnerBank will work. It seems likely that Home Depot will use its contractors to market EnerBank's loan services to home improvement customers employing the contractors' services. This relationship is sure to cause confusion for the loan applicants, and raise questions regarding customer protections under the Truth in Lending Act and other required consumer disclosure laws.

Will the customers know that the loan is not tied to the purchase of products from Home Depot, especially since their first point of contact will be a contractor and not a loan officer from the bank? Will the customer be given the opportunity to shop around for better offers, or even know that they can ask their contractor to purchase materials from home improvement stores other than Home Depot? Will there be other incentives provided to borrowers to become Home Depot customers, or EnerBank customers? Will goods be discounted, but credit rates high, or credit rates low, but the price of Home Depot goods high? Or will discounts accrue to the benefit of the contractor and not the borrower-homeowner? The business plan and structure of the arrangement virtually guarantees that there will be conflicts of interest.

The mixing of banking and commerce presented in the Home Depot and Wal-Mart applications raises yet another likely conflict of interest; granting these applications would undermine the impartial allocation of credit. Home Depot's bank will clearly have a major incentive to make loans that will benefit Home Depot, rather than its competitors. If Wal-Mart expands its business plan and begins to take deposits from its customers, it is virtually impossible to believe that those deposits would be lent to a competing business. In both cases, local businesses now served by local banks would lose a critical source of credit.

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<sup>10</sup> Change in Control Notice, page 10.

<sup>11</sup> Change in Control Notice, page 10.

***Proposed Home Depot/EnerBank Transactions Illegal***

In fact, as structured the arrangement is predicated on illegal affiliate transactions under Section 23A of the Federal Reserve Act<sup>12</sup> and Federal Reserve Regulation W. These laws place quantitative limits on transactions between a bank and its affiliates. Section 23A prohibits a member bank from engaging in a “covered transaction” with an affiliate if the aggregate amount of the bank’s covered transactions with an affiliate would exceed 10% of the bank’s capital stock and surplus. Even if EnerBank is not a Federal Reserve member bank, Section 23A still applies. The Federal Deposit Insurance Corporation Act applies Section 23A to every nonmember insured bank in the same manner that it applies to a member bank.<sup>13</sup>

It is clear that some of the proceeds of EnerBank’s home improvement loans will be used to purchase goods and services from Home Depot, thereby benefiting Home Depot. For instance, Home Depot’s notice states that “EnerBank’s contractor delivery model will deepen our relationship with contractors—and we believe that will help us earn more of their business.” Section 23A and Federal Reserve Regulation W state that a “member bank must treat any of its transactions with any person as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate.”<sup>14</sup> Therefore, any proceeds of EnerBank’s home improvement loans used to purchase goods at Home Depot must be considered “covered transactions” and therefore subject to the quantitative limits of Section 23A, since the proceeds of those loans will benefit an affiliate—Home Depot.<sup>15</sup>

In light of the stated business plan of Home Depot and EnerBank, it is highly likely that these covered transactions will exceed the 10 percent limit allowable under Section 23A and Regulation W.

***ILC Expansion Would Destabilize Local Communities and Harm Consumers***

It would be absurd to assert that community banks seek to close the ILC loophole because they fear competition. Community bankers welcome competition. Community bankers compete with thousands of other community banks, large regional and nationwide banks, tax-subsidized credit unions and farm credit

<sup>12</sup> 12 U.S.C. Section 371c.

<sup>13</sup> See 12 U.S.C. Section 1828(j).

<sup>14</sup> See 12 U.S.C. 371c(a)(2) and 12 CFR 223.16.

<sup>15</sup> Based on a previous letter ruling issued by the Federal Reserve in 1996 involving American State Bank in Wilson, Arkansas, we believe that the Federal Reserve would consider EnerBank’s home improvement loans to be “covered transactions” under Section 23A.<sup>15</sup> In the American State Bank situation, the bank extended crop production loans to local farmers, including farmers who leased land from an affiliate. Since the affiliate received lease payments from the farmers based on the farmers’ income, the Federal Reserve ruled that the affiliate indirectly benefited from the bank’s crop production loans and therefore the loans were “covered transactions” under Section 23A. See Federal Reserve Board letter issued to Ms. Charla Jackson of American State Bank, August 26, 1996.

associations, securities firms and equity dealers, mortgage brokers and real estate companies, non-regulated finance companies and payday lenders, the local post office and Western Union, and the list goes on. Community bankers not only welcome competition, we thrive on it. Healthy and fair competition stimulates the development of new product and service lines that not only help our bottom line, but create real value for our customers. To suggest that community bankers are afraid of competition is uninformed, unwarranted, and only diverts attention away from the real policy issues.

#### ***The Wal-Mart Bank***

In addition to its stated plan to stake out a major position in the nation's payments system, Wal-Mart could easily change its business plan and open retail operations throughout its network of stores. Wal-Mart has the size and resources to engage in predatory pricing for as long as it takes to drive local competitors out of the market – not only community banks, but other locally owned small businesses as well. A community bank is only as strong as the community it serves. If our small business customers are driven out of business and our communities are damaged, our deposit base will suffer, our earning assets will decline, and the level of resources available for capital development and community lending will deteriorate.

Small businesses, including community banks, bring value well beyond their assets to a community through local ownership, hands-on knowledge of the community and a stakeholder commitment to the community. Community banks provide funding and support for local businesses and economic development projects. Community bankers and the small business owners they support not only volunteer hundreds of hours a year to serve on school and hospital boards and other civic organizations, but we also donate many thousands of dollars every year to civic causes. We do this because we live in the community, take pride in the community, and have a financial stake in the community. We stay with the community in good times and in bad. Our concern is that the Bentonville, Arkansas-based owners of Wal-Mart will not share in this commitment, as has been demonstrated in community after community where Wal-Mart stores shut down when the bottom line got too small. Various retail outlets competing with Wal-Mart have charged that it engages in predatory pricing practices to capture market share, then raises prices once competitors are eliminated. If the bottom line gets too small, they abandon the community.<sup>16</sup> Locally owned businesses do not abandon their communities when the times get tough.

#### ***Home Depot***

A Home Depot-owned bank, like a Wal-Mart bank, would create competitive imbalances in the banking industry and inflict lasting damages on community banks and thereby the communities they serve.

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<sup>16</sup> See, e.g., When Wal-Mart Pulls Out, What's Left?, *New York Times*, March 5, 1995; Store Shuts Doors on Texas Town; Economic Blow for Community, *USA Today*, October 11, 1990; Arrival of Discounter Tears Civic Fabric of Small-Town Life, *Wall Street Journal*, April 14, 1987.

There is no evidence that the credit needs of home improvement loan customers are not being met by conventional sources, such as banks, thrifts and credit unions. Indeed, community financial institutions are constantly looking for new opportunities to serve their customers, build their communities, and strengthen their loan portfolios, and most have ample available lendable funds to do so.

Neither is there any evidence that Home Depot needs an additional credit outlet for its home improvement customers. Indeed, Home Depot states in its notice that it "already finance[s] home improvements with credit cards and home improvement loans marketed directly to consumers."<sup>17</sup> With Home Depot's profits growing at a rate of 17% annually, these methods are obviously working, raising questions about the need for an additional source of credit for Home Depot's customers. It is unclear in the application whether these direct marketing efforts will cease or continue if Home Depot acquires EnerBank.

We are also concerned that a Home-Depot-owned bank would have the size and resources to engage in predatory pricing to capture the local home improvement loan market to the detriment of locally-owned banks. With Home Depot's resources backing EnerBank, it would have the ability to unfairly undercut loan rates offered by local banks, resulting in lost business opportunities and lower earned interest for community banks.

The marketing technique that Home Depot intends to employ with EnerBank could reduce competition and ultimately result in higher costs for consumers. And even though the notice states loan will not be specifically tied to a Home Depot purchase, since the contractor would be introduced to the bank through Home Depot, this no doubt would build a loyalty to Home Depot products, exactly what Home Depot's stated purpose is.

In addition, EnerBank would actually train contractors to close deals, presenting concerns regarding adequate provision of consumer disclosures such as Truth in Lending disclosures, etc. These contractors are neither employees of Home Depot nor the bank, raising concerns about who will ensure consumers receive proper disclosures and other legally required information.

ICBA also is concerned that there is nothing to prevent Home Depot from expanding its business plan for EnerBank down the road, even though Home Depot has described a very limited business plan in the public portion of its notice and stated that it has no plans to offer traditional banking services. With more than 2,000 locations in North America, should Home Depot decide to expand into retail branch banking, it would have a ready made brick and mortar network in place to create one of the largest branch banking operations in the nation. Considering the volatile nature of the home improvement industry, there is no way to predict how Home Depot's business plans would change if there were a sudden downturn in the industry. Were Home Depot to engage in retail banking through such a network of branches, it would pose a serious competitive

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<sup>17</sup> Change in Control Notice, page 11.

threat to the community banking industry and to the health of local communities in much the same way that a retail Wal-Mart bank would pose such a threat.

#### ***Credit Union ILC Applications***

Credit unions have also applied for ILC charters. In California, the giant Wescom Credit Union, with over \$3 billion in assets, has applied to acquire an existing ILC, while a group that includes Corporate One Credit Union and CUNA Mutual, had sought to charter a Utah ILC. Both cases represent attempts by tax exempt entities regulated by one financial agency (NCUA) to use a charter regulated by another (FDIC) to avoid restrictions on their fields of membership. This is a particularly bizarre turn of events, particularly because the NCUA is commonly considered a less effective regulator than the FDIC. It is hard to determine which is worse, an ILC controlled by a completely unsupervised – but tax paying – firm, or an ILC controlled by an inadequately supervised and tax exempt institution.

ICBA believes that neither outcome is acceptable and Congress should step in as soon as humanly possible.

#### **New Legislation is Necessary to Maintain a Safe, Sound, and Objective Financial System**

Senator Garn told the FDIC that the ILC charter was grandfathered in 1987 and exempted from the Bank Holding Company Act to serve narrow purposes. Until recently, that is how most ILC holding companies used their charters. But that is rapidly changing, as the Wal-Mart and other applications demonstrate. The growing popularity of the ILC charter and its proposed use for broader purposes demonstrates that the narrowly intended ILC exception could eventually swallow the general rule. A charter based in one state could begin dominating the nation's payments system, become a dominant home improvement financier, and even further broaden the field of membership for tax-exempt credit unions.

Unfortunately, the FDIC currently lacks clear statutory authority to take all of these broad policy implications into account as it considers the pending ILC applications. While ICBA believes that the FDIC has ample grounds to deny several of the pending applications, especially the ones filed by Wal-Mart and Home Depot, it may eventually be compelled to grant a disturbing number of them. So, clearly it is time for Congress to revisit the ILC loophole and take effective steps to close it. That is essential to maintain the safety and soundness of our financial system and prevent conflicts of interest that would damage the new Deposit Insurance Fund, consumers, and potentially taxpayers.

The Government Accountability Office produced a report on the ILC phenomenon last year. It discussed the need for enhanced supervision of ILCs, and especially the need for consolidated supervision over both the ILCs and their holding companies. Key portions of the report are worth repeating at some length:

Because most ILCs exist in a holding company structure, they are subjected to risks from the holding company and its subsidiaries, including adverse intercompany transactions, operations, and reputation risk, similar to those faced by banks and thrifts existing in a holding company structure. However, FDIC's authority over the holding companies and affiliates of ILCs is not as extensive as the authority that consolidated supervisors have over the holding companies and affiliates of banks and thrifts. For example, FDIC's authority to examine an affiliate of an insured depository institution exists only to disclose the relationship between the depository institution and the affiliate and the effect of that relationship on the depository institution. Therefore, any reputation or other risk from an affiliate that has no relationship with the ILC could go undetected. In contrast, consolidated supervisors, subject to functional regulation restrictions, generally are able to examine a nonbank affiliate of a bank or thrift in a holding company regardless of whether the affiliate has a relationship with the bank. FDIC officials told us that with its examination authority, as well as its abilities to impose conditions on or enter into agreements with an ILC holding company in connection with an application for federal deposit insurance, terminate an ILC's deposit insurance, enter into agreements during the acquisition of an insured entity, and take enforcement measures, FDIC can protect an ILC from the risks arising from being in a holding company as effectively as with the consolidated supervision approach. However, we found that, with respect to the holding company, these authorities are limited to particular sets of circumstances and are less extensive than those possessed by consolidated supervisors of bank and thrift holding companies. As a result, FDIC's authority is not equivalent to consolidated supervision of the holding company.

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As a result of their authority, consolidated supervisors take a systemic approach to supervising depository institution holding companies and their nonbank subsidiaries. Consolidated supervisors may assess lines of business, such as risk management, internal control, IT, and internal audit across the holding company structure in order to determine the risk these operations may pose to the insured institution. These authorities enable consolidated supervisors to determine whether holding companies that own or control insured depository institutions, as well as holding company nonbank subsidiaries, are operating in a safe and sound manner so that their financial condition does not threaten the viability of their affiliated depository institutions. Thus, consolidated supervisors can examine a holding company subsidiary to determine whether its size, condition, or activities could have a materially adverse effect on the safety and soundness of the bank even if there is no direct relationship between the two entities. Although the [Federal Reserve] Board's and OTS's examination authorities are subject to some limitations, as previously noted, both the Board and OTS maintained that these limitations do not restrict the supervisors' ability to detect and assess risks to an insured depository institution's safety and soundness that could arise solely because of its affiliations within the holding company.<sup>18</sup>

Representative Jim Leach's bill, the Financial Safety and Equity Act of 2005 (H.R. 3882), provides the ideal solution to this problem. It would require that any company that owns an ILC conform to the Bank Holding Company Act by

<sup>18</sup> GAO report number GAO-05-621, 'Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority,' September 22, 2005.

becoming a financial holding company. That would require companies to divest non-financial activities. All ILC holding companies would undergo the same regulation and supervision by the Federal Reserve that applies to owners of banks that are not ILCs under the Bank Holding Company Act under the 1999 Gramm-Leach-Bliley Act. Companies would have five years to divest non-conforming activities.

ICBA commends Mr. Leach for his leadership. His work was critical in earlier efforts to close the nonbank bank and unitary thrift holding company loopholes. In fact, the bill that closed the latter loophole bears his name, the Gramm-Leach-Bliley Act. Without his pioneering work, the separation of banking and commerce would have been long-since lost and we would be likely dealing with the severe problems that would have ensued.

Therefore, ICBA believes that Congress would best serve the public interest by enacting Mr. Leach's bill. If that is not possible, Congress is fortunate to have a strong alternative plan drafted by Representatives Paul Gillmor and Barney Frank. Like Rep. Leach, Reps. Gillmor and Frank have worked tirelessly to address the ILC challenge. They wrote the Gillmor/Frank legislative language that would prevent commercially owned ILCs chartered after October 2003 from using de novo interstate branching authority and the business checking powers that have repeatedly passed the House.

Recently, they worked to obtain the signatures nearly 100 of their colleagues on a bi-partisan letter to the FDIC urging the agency "to impose a moratorium on approving any applications for deposit insurance for any new industrial loan companies (ILCs) owned by commercial firms and on approvals for acquisitions of existing ILCs until Congress has had an opportunity to consider the ILC issue."<sup>19</sup> This hearing represents the beginning of that process. ICBA strongly urges the new FDIC Chairman, Sheila Bair, to follow this recommendation.

Reps. Gillmor and Frank have built on this strong record and drafted legislation, the Industrial Bank Holding Company Act of 2006 (H.R. 5746), that would address both elements of the ILC loophole – the separation of banking and commerce and the need for consolidated supervision of ILC holding companies.

Like much good legislation, the Gillmor/Frank bill includes compromises. However, it would prevent the FDIC from approving any applications by commercial firms for new ILCs or for acquisitions of existing institutions. Commercially owned ILCs established or acquired between October 1, 2003 and June 1, 2006 would be grandfathered, but could only engage in activities they were engaged in on May 31, 2006 and could not branch outside their home state. All other ILCs – "pre-2003" – would be allowed to engage in any legal activity, provided there was no change in ownership. The bill would establish the FDIC, rather than the Federal Reserve, as the consolidated regulator for ILC holding companies.

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<sup>19</sup> Letter to The Honorable Martin J. Gruenberg, Acting Chairman, FDIC, June 8, 2006.

The ICBA strongly endorses the new Gillmor/Frank bill, while acknowledging that it is a compromise. It would be ideal to close the loophole for existing commercial ILC owners as well as commercial firms' applications for ILC formations and acquisitions, but we recognize the difficulty of that approach. We also want to be assured that the FDIC will have all the tools they will need to be an effective consolidated regulator. For example, it is important that the bill provides the consolidated supervisor power to order an IBHC to divest a subsidiary that could have a negative impact on the industrial bank, a power under the Bank Holding Company Act.

### **Conclusion**

It has now become urgent that Congress enact comprehensive reform legislation to address the ILC loophole. This issue has gone well beyond the interests of a few companies in a handful of states. What Congress grandfathered nearly 20 years ago as a narrow exception to the separation of banking and commerce and consolidated holding company supervision threatens to quickly become a way for the nation's retail and industrial firms to enter into full service banking. There are 13 applications for ILC charters or acquisitions pending today. More will almost certainly be filed. The financial system's safety and soundness, integrity, and ability to serve local communities and small businesses are all at great risk. Fortunately, Congress has before it strong legislative proposals that will effectively address these risks. ICBA urges Congress to take prompt and positive action.

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Testimony of

G. EDWARD LEARY

COMMISSIONER OF FINANCIAL INSTITUTIONS

STATE OF UTAH

Before the  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
AND CONSUMER CREDIT OF THE COMMITTEE  
ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

JULY 12, 2006

Good morning, Chairman Bachus and members of the subcommittee, thank you for the opportunity to testify on Industrial Banks (IB) or as they are sometimes known Industrial Loan Corporations (ILC).

I am Edward Leary, Commissioner of Financial Institutions for the State of Utah. I have been involved with banking for thirty-two years. First as a community banker, then fifteen years in bank examiner positions with the Utah Department and for the last fourteen years as its Commissioner. I am pleased to be here today to share my views on this industry.

### STATE CHARTER OPTION

As we all know, banking is integral to the fabric of economic life for all of us. Since the founding of this nation, states have chartered, regulated and supervised banking. The choice of charter remains a vital component of the check and balances of the dual banking system. State-chartered institutions in attempting to survive and meet the needs of their communities have fostered creativity and experimentation. The state-chartered institutions can innovate in a controlled environment that limits systemic risks. If a product, service, delivery mechanism or charter is fundamentally unsafe or unsound then those weaknesses may be exposed.

Today largely as a result of the states success in performing that role, the state charter remains a viable, though as a result of federal preemption, less appealing choice for banks, especially large interstate operations.

This capacity for innovation is particularly true of the industrial bank charter.

Another foundation of the dual banking system is the ability to freely choose the supervisory structure under which the insured entity operates. This foundation contributes to a competition in excellence among financial institution regulators. It is therefore vital that there is more than one approach to the regulation and supervision of financial institutions.

If I was invited to participate in this hearing today because of Utah's history and experience in chartering and regulating industrial banks, my view and statement is that industrial banks are the embodiment of what is right and proper in the dual banking system.

I would like to reference a thought-provoking statement from the former Federal Reserve Chairman, Alan Greenspan,

*"A system in which banks have choices, and in regulations that result from the give and take involving more than one agency, stands a better chance*

*of avoiding the extremes of Supervision.” (No Single Regulator for Banks, Wall Street Journal, December 15, 1993.)*

#### **WHAT THE PUBLIC POLICY DEBATE SHOULD BE**

The fact that the subcommittee is having this hearing today reflects the reality that Utah’s chartering and regulating of the industrial banks has been commensurate to the risk. Utah, in partnership with the FDIC, has jointly created a supervisory model for industrial banks that has evolved and will likely continue to evolve, but through twenty years of everyday application, it has worked, in that no Utah industrial bank has failed.

My belief is that this committee should not consider rewriting banking laws to address the desires of particular industry groups or trade associations whose desire is to suppress competition.

Nor should Congress change, much less outlaw a proven, successful regulatory structure because some groups have concerns about a particular applicant.

Testifying before Congress on financial services reform in 1987, the FDIC’s then-chairman L. William Seidman argued that the public interest would be best served by,

*“A ... financial services industry that met four objectives: the financial system should be viable and competitive, the banking system should be operated in a safe and sound manner, customers should realize benefits from enhanced competition, and the system should be flexible enough to respond to technological change. Consistent with these objectives, the regulatory and supervisory structure of banking should be the simplest and least costly one available.*

The question facing policy makers then was - and continues to be - whether these objectives can be met without restricting the ability of banks to choose the corporate structure that best suits their business needs. As Seidman noted:

*The pivotal question . . . is: Can a bank be insulated from those who might misuse or abuse it? Is it possible to create a supervisory wall around banks that insulates them and makes them safe and sound, even from their owners, affiliates and subsidiaries? If so, then the banking and commerce debate should focus on how affiliations should be regulated so that the public interest is met.” (FDIC Banking Review, January 2005, The Future of Banking in America, The Mixing of Banking and Commerce: Current Policy Issues, Volume 16, No. 3.)*

I urge this committee and Congress to focus on the adequacy of the current regulatory processes conducted by the State of Utah and the FDIC. In the absence of a demonstrated example of regulatory failure, there is no fundamental, underlying reason for a public policy change.

If, in the future, shortcomings are identified, an amendment may be considered without outlawing a class of banks that have operated for over a century without harming competitors, consumers or the deposit insurance system. Believe me, if I am still the Commissioner when a shortcoming in our regulatory process is identified, it will be corrected, long before any legislative body could take action. The states and the FDIC have developed prudential standards that are in place today.

**UTAH'S REGULATORY STRUCTURE & EXPERIENCE IN PARTNERSHIP WITH THE FDIC**

Utah has been chartering industrial banks since the 1920s. In 1986, Utah law was changed to require Federal Deposit Insurance for all industrial banks.

Like most state banking departments, Utah regulates all types of state-chartered depository institutions, including banks, industrial banks and credit unions. The Utah department also has jurisdiction over many non-depository activities. The Utah department is entirely funded from assessments to the financial institutions we regulate through a restricted account that can only be appropriated to the department.

As state-chartered, FDIC insured institutions, industrial banks are currently operating in the states of Utah, California, Colorado, Hawaii, Indiana, Nevada and Minnesota. No state permits industrial banks to engage in activities that are not permissible for other state-chartered banks.

Industrial banks are subject to the same banking laws and are regulated in the same manner as other depository institutions. They are supervised and examined both by the states that charter them and by the FDIC. They are subject to the same safety and soundness, consumer protection, deposit insurance, Community Reinvestment Act, and other requirements as other FDIC-insured banks. However, special emphasis is placed on Federal Reserve Regulation W and Sections 23 A & B of that Regulation which closely regulates all parent and affiliate company transactions to ensure that there is a limit to the amount of "covered transactions" and an "arms length" basis for all transactions.

A Utah industrial bank is required to maintain the minimum amount of capital required

by its federal deposit insurer, but the Commissioner may require a greater amount of capital.

The department has and will continue to defend (in partnership with the FDIC) our regulation and supervision of the industrial bank industry. The department takes its supervisory role seriously. It is an active participant with the FDIC in all industrial bank examinations and targeted reviews wherever they are conducted in the country. Our examiners are participating in large loan exams (reviewing loans and lines-of credit in the \$100's of millions), capital market examinations, trust exams, information system exams, consumer compliance and community reinvestment exams and bank secrecy act and anti-money laundering exams.

Utah believes it is a full partner with the FDIC in regulating, supervising and examining this industry. As proof of that fact, Utah is one of the very few states in the country performing CRA/Compliance examinations. Utah conducts most of these examinations jointly with the FDIC or Federal Reserve. To solidify this relationship with the FDIC, Utah signed a written agreement in January of 2004. Since that time Utah has participated on almost all CRA/Compliance examinations conducted by both federal agencies.

Utah is participating with the FDIC in the Large Bank Supervision Program for four industrial banks: Merrill Lynch Bank USA, UBS Bank, American Express Centurion Bank and Morgan Stanley Bank. The supervision of these large banks is coordinated by a full-time relationship manager for the State as well as the FDIC.

A team of examiners and specialists from Utah and the FDIC conduct targeted reviews in areas such as: commercial and retail credit, capital markets, bank technology, asset management, and compliance and they track the quality and quantity of risk management procedures. I think it is noteworthy that in June, fifteen examiners from Utah completed a three week targeted examination in Chicago as part of a loan review and analysis of wholly-owned subsidiaries for one of the large industrial banks. This type of activity is no longer extraordinary. Utah is doing this kind of examination on a routine basis.

The large bank program allows the State and FDIC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the three years Utah has been involved in this program, we have developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex and to some degree globally positioned banks.

Some industrial banks tend to specialize in specific banking activities such as credit card, home mortgage, automobile, agricultural, loans secured by brokerage accounts or small business lending. This specialization has resulted

in critics challenging the safety and soundness of these institutions. However, the FDIC has stated that industrial banks are no more a threat to the deposit insurance fund than commercial banks.

What Utah is engaged in is, "Bank-up or bottom-up supervision" of the industrial bank's parent company. The FDIC has more accurately described the regulatory structure as "Bank-Centric." This is not a new concept when examining a bank that is part of a holding company structure. Industrial banks based in Utah have been a "laboratory" for those insured institutions owned by commercial entities. The evolving supervisory approaches of Utah and the FDIC have helped fine-tune processes and procedures that insulate an insured depository institution from potential abuses and conflicts of interest by a non-federally supervised parent. Critical controls have been developed as the result of cooperation between Utah regulators and the FDIC.

#### **BANKING & COMMERCE**

To me, the "separation of banking and commerce" is a debatable notion, not a reality. There have always been ways for commercial interests to affiliate with banks, and the ability of regulators to prevent abuses continues to evolve and strengthen.

Conversely, as the experience of the conventional banking industry shows, the wall separating banking and commerce is elastic.

A number of the members of this Committee will remember when the securities and insurance industries cited this principle as a mantra to keep banks from entering those lines of business.

Those of you who served in Congress at the time will recall that the Gramm-Leach-Bliley Act changed the test for bank activities from "closely related to banking" to those "of a financial nature" thereby, allowing banks to enter the securities and insurance industries (to the point where a few mega-banks dominate the former).

The elasticity of the test is demonstrated by the debate over whether real-estate brokerage is a financial activity.

I recognize that today's hearing is about the regulation of industrial banks, not a debate over banking and commerce. But I believe this argument should not be used as a stalking horse by those advocating an anti-competitive position to dismantle an entire segment of the financial services sector.

The industrial loan experience, like the experience of credit card banks, non-bank

banks and other institutions with commercial parents, shows that fears about banking and commerce are unfounded. The history of industrial banks is a testament that the regulatory model has maintained the safety and soundness of these institutions. The track record demonstrates that banks can be safely operated as parts of diversified holding companies. Congress has already given the FDIC the authority it needs to take "prompt corrective action" to prevent abuses by the holding company and wall off the bank from risk. Utah examiners work with the FDIC to examine the banks and holding company affiliates that touch the bank.

#### **EXAMINE THE FACTS IN A WORST CASE SCENARIO**

In this discussion and others the worst case scenario that detractors have postulated is that of a holding company filing bankruptcy or getting into financial difficulty. The reality is that Utah and the FDIC have experienced both. While no regulator relishes stressful circumstances, we can state that we weathered the storm. Utah has had large corporate parents of industrial banks encountering financial difficulties, and in one instance the ultimate parent company filed for bankruptcy protection.

The background and outcome were well described by the FDIC in the January 2005, *FDIC Banking Review, The Mixing of Banking and Commerce: Current Policy Issues*,

*"The bankruptcy of the corporate owner of an ILC - Conseco Inc - but not of the ILC itself illustrates how the bank-up approach can effectively protect the insured entity without there being a BHC-like regulation of the parent organization. Conseco Inc. was originally incorporated in 1979 as Security National of Indiana Corp. After several years of raising capital, it began selling insurance in 1982. Security National of Indiana changed its name to Conseco Inc. in 1984, after its 1983 merger with Consolidated National Life Insurance Company. Conseco Inc. expanded its operations throughout the 1980s and 1990s by acquiring other insurance operations in the life, health, and property and casualty areas. Conseco Inc. was primarily an insurance company until its 1998 acquisition of Green Tree Financial Services. A diversified financial company, Green Tree Financial Services was one of the largest manufactured-housing lenders in the United States. Upon acquisition, it was renamed Conseco Finance Corporation. Included in the acquisition were two insured depository charters held by Green Tree Financial Services - a small credit-card bank chartered in South Dakota and an ILC chartered in Utah. Both of these institutions were primarily involved in issuing and servicing private-label credit cards, although the ILC also made some home improvement loans.*

*The ILC - Green Tree Capital Bank - was chartered in 1997 and changed its name to Conseco Bank in 1998 after the acquisition. Conseco Bank was operated profitably in every year except the year of its inception, and grew its equity capital from its initial \$10 million in 1997 to just over \$300 million in 2003. Over the same period, its assets ballooned from \$10 million to \$3 billion.*

*Conseco Bank was supervised by both the Utah Department of Financial Institutions and the FDIC. Despite the financial troubles of its parent and the parent's subsequent bankruptcy (filed on December 18, 2002), Conseco Bank's corporate firewalls and the regulatory supervision provided by Utah and the FDIC proved adequate in ensuring the bank's safety and soundness. In fact, \$323 million of the \$1.04 billion dollars received in the bankruptcy sale of Conseco Finance was in payment for the insured ILC - Conseco Bank, renamed Mill Creek Bank -which was purchased by GE Capital. As a testament to the Conseco Bank's financial health at the time of sale, the \$323 million was equal to the book value of the bank at year-end 2002. Thus, the case of Conseco serves as an example of the ability of the bank-up approach to ensure that the safety and soundness of the bank is preserved."*

In another case, TYCO, a large parent company of a Utah industrial bank called CIT Online Bank encountered financial difficulties and decided to spin the industrial bank group off in an initial public offering which was approved and completed. In spite of TYCO's financial difficulties, the Utah industrial bank continues operations today as CIT Bank.

#### **HOLDING COMPANY SUPERVISION**

There is no single "right" way to oversee entities that own a bank. The bank holding company model works well for companies whose principal business is limited to banking – it was devised at a time when bank holding companies were permitted to do nothing else. The existing industrial bank supervisory process works well. Utah thinks it is the *superior* model for holding companies whose principal business may not be banking.

What has received no coverage in the current debate is the fact that industrial bank oversight by the states and the FDIC is supplemented by holding company oversight by financial regulators other than the Federal Reserve. The Securities and Exchange Commission (SEC) and the Office of Thrift Supervision (OTS) have regulatory oversight over many holding companies with Utah industrial bank subsidiaries. They have approximately 75% of industry assets under their jurisdiction. If the Federal Reserve's holding company's supervision of UBS Bank USA and Universal Financial Corp. (owned by CitiGroup) assets are

included that brings the industry's oversight by federal regulators to 90% of Utah assets as of March 31, 2006.

In Utah, the specifics are: UBS Bank USA with \$19 billion in total assets as of March 31, 2006, the second largest industrial bank and Universal Financial Corp. with \$535 million in total assets, are both subsidiaries of Financial Holding Companies subject to Federal Reserve jurisdiction. Many other large industrial banks including: American Express Centurion Bank with \$14 billion in total assets, GE Capital Financial with \$2 billion in total assets, Lehman Brothers Commercial Bank with \$3 billion in total assets and Merrill Lynch Bank USA with \$62 billion in total assets all have Federal Savings Bank affiliates and therefore their parent companies are also subject to the jurisdiction of the OTS. Additionally, in a Consolidated Supervised Entity environment the holding companies of Goldman Sachs Bank, Lehman Brothers Commercial Bank, Merrill Lynch Bank USA and Morgan Stanley Bank with \$11 billion in total assets are subject to the jurisdiction of the SEC.

Not included in the totals above but consideration should be given to three additional Utah industrial banks: Advanta Bank with \$1.6 billion in total assets, Target Bank with \$12 million, and World Financial Capital Bank with \$196 million in total assets, all of which have sister national banks chartered by the Office of the Comptroller of the Currency (OCC).

In this discussion, I think we need to keep in perspective that the entire industrial loan industry, even with its growth during the last twenty years, is only approximately 1.5% of banking assets.

The parent companies of the vast majority of industrial bank assets are engaged exclusively or predominantly in financial services activities. These include: Advanta, American Express, Citigroup, Merrill Lynch, Morgan Stanley and UBS. Other industrial banks are owned by diversified companies, such as General Electric and GMAC which engage in both financial and non-financial activities. Some are controlled by companies primarily engaged in commercial or industrial activities, such as BMW and Volkswagen. However, both BMW and Volkswagen have extensive bank operations in Europe.

It should be noted that the important fact of other federal agency oversight of industrial bank parents was given scant attention in the GAO's report on Industrial Loan Corporations. The GAO report also did not uncover a single example of the regulatory failure, or a problem that could have been averted with a different form of holding company oversight.

While not subject to regulation as bank holding companies, industrial bank owners are subject to many of the same requirements as bank holding companies. As a result,

safeguards already exist to protect these depository institutions against abuses by the companies that control them or activities of affiliates that might jeopardize the safety and soundness of the institutions or endanger the deposit insurance system.

For example, restrictions on transactions with affiliates in Sections 23A and 23B of the Federal Reserve Act apply to industrial banks and their owners. These provisions limit the amount of affiliate loans and certain other transactions (including asset purchases) to 20 percent of a bank's capital, and require that such loans be made on an arm's length basis. Thus, an industrial bank may not lawfully extend significant amounts of credit to its holding company or affiliates or offer credit to them on preferential or non-market terms. All loans by industrial banks to their affiliates must be fully collateralized, in accordance with Section 23A requirements.

Utah law establishes, besides all other jurisdiction and enforcement authorities over industrial banks, that pursuant to Section 7-8-16 each industrial bank holding company must register with the department and is subject to the department's jurisdiction. Also, according to Section 7-1-501 of the Utah Code each industrial bank holding company is subject to examination and enforcement authority of the department.

Utah financial institutions, including industrial banks supported a fee increase bill during the last session of the Utah Legislature. This is important because it demonstrates how serious the industry is about supporting and maintaining quality regulation and supervision. The fee increase allows Utah to continue our tradition of excellence in supervision, in joint safety and soundness examinations, in specialty examinations and in training. The fee increase will allow Utah to hire five more financial institutions examiners bringing the total number of examiners to forty-two. The department will provide further training to the cadre of existing holding company examiners and increase the number of qualified examiners so that Utah can conduct, independently, if need be, holding company inspections of all financial institution holding companies registered in Utah.

Through its role as primary regulator of state-chartered nonmember banks including industrial banks, the FDIC provides the bank-centric regulatory alternative for organizations and individuals that choose not to be regulated by the Federal Reserve under a holding company structure. Thus, this model offers greater flexibility for corporate enterprise, while managing the risks posed by a mixing of banking and commerce. Without this alternative regulatory structure, the ability of the market to meet the demands of consumers could be severely restricted.

I struggle to understand why Congress would want to keep out well-capitalized innovative entrants to the market? While the banking system is becoming concentrated in the hands of a few large institutions with huge market power and system risk. I understand that the five largest banks are trillion dollar entities,

which control a third of industry assets and deposits, and a fourth of all bank branches.

**ADDITIONAL PRUDENTIAL SAFEGUARDS APPLIED TO INDUSTRIAL BANKS**

The question then may be. Can a bank, regulated at the bank level, be insulated and isolated from parent company improprieties? The Federal Reserve has staked out the umbrella regulator role from the top down. Utah believes that regulatory scrutiny can also be accomplished from the bank up. At least in our mind, the case has not been made that it does not work. In fact the track record of Utah industrial banks after twenty years of dual supervision from the state and FDIC is that there is no extraordinary risk in doing so. However, I would be the first to add that the industry requires additional prudential safeguards. Supervising industrial banks is an evolving regulatory dynamic. As new issues arise and new lessons are learned, I suspect we will add new requirements.

This enhanced regulatory oversight is most evident in approval Orders of de novo industrial banks. The Order is where the majority of prudential safeguards are issued and remain in effect for the life of the institution. These Orders reflect generally higher capital standards and more regulatory attention to previously noted problems.

Today, all Utah industrial bank approval Orders contain the following:

The board of directors shall be comprised of a majority of outside - unaffiliated directors, and those unaffiliated directors shall not serve on the board of any other FDIC insured depository institution. (I should note that these director independence requirements were imposed long before the Sarbanes Oxley Act of 2002.)

There shall be no change in the executive officers or in the board of directors as submitted in the application without the prior approval of the Commissioner for a period of three (3) years after the industrial bank commences operations.

Requires at a minimum an onsite President, Chief Financial Officer, and Chief Credit Officer with sufficient support staff with the knowledge, ability, and expertise to successfully manage the risks of the industrial bank, maintain direct control of the industrial bank, and retain the industrial banks independence from the parent company.

Within 30 days of receiving all required regulatory approval to operate as an insured Utah industrial bank, the industrial bank holding company shall register with the department by filing a registration statement as required

by Utah law.

**SUMMARY**

Utah has been successfully regulating FDIC insured industrial banks for twenty years. Utah has established a record of safe and sound institutions with prudential safeguards in place that have prevented parent companies from exercising undue influence over the insured entity.

Utah's industrial banks are well capitalized, safe and sound institutions.

Utah's industrial banks are subject to the same regulations and are examined in the same manner as other banks.

Utah views our brand of regulation as tough but fair. An essential component of our brand of regulation is to require on-site management from bank-experienced people.

Utah and FDIC examiners have adapted as the industrial banks have evolved. For us, keeping up with new products, new financial instruments and new delivery mechanisms has been a regulatory challenge, but a challenge we have met with the shared resources of our regulatory partners, both state and FDIC.

In this discussion, the reality check is that the entire industrial loan industry, even with its growth of the last twenty years, is only approximately 1.5% of banking assets. Utah's vision of the industrial bank industry was to advance and enhance the image of Utah and the state charter. The department envisioned Utah as a financial services center. In keeping with that vision, Utah expects financial institutions to be safe, sound, well capitalized and well managed. We expect the best corporate conduct by all industrial banks chartered in Utah. Utah also expects the best performance of ourselves as a regulator. It does not advance or enhance the state's image if we do not succeed.

TESTIMONY OF  
GEORGE SUTTON, ESQUIRE  
ON BEHALF OF  
THE SECURITIES INDUSTRY ASSOCIATION

BEFORE THE  
HOUSE FINANCIAL SERVICES COMMITTEE  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT  
“ILC’s – A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES”

JULY 12, 2006

**Introduction**

Mr. Chairman and members of the subcommittee, I am George Sutton and I appear today on behalf of the Securities Industry Association (SIA).<sup>1</sup>

I am an attorney with the firm of Callister, Nebeker and McCullough in Salt Lake City, Utah. My firm represents SIA on state issues in Utah, along with many commercial and community banks and banking trade associations. We also represent about half of the industrial loan banks (“industrial banks”) based in Utah, including several of the banks owned by SIA members. Prior to commencing my law practice I served briefly as the CEO of an industrial bank. Before that I served for over nine years with the Utah Department of Financial Institutions. From 1987 to 1992 I was the state’s Commissioner of Financial Institutions.

At year-end 2005, industrial banks owned by securities firms held more than 75 percent of the \$120 billion in assets held by industrial banks in Utah. The continued viability of the

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<sup>1</sup> The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2005, the industry generated an estimated \$322.4 billion in domestic revenue and an estimated \$474 billion in global revenues. (More information about SIA is available at: [www.sia.com](http://www.sia.com).)

industrial loan bank charter is critically important to the securities industry. We are grateful for the opportunity to explain why any attempt to alter the industrial loan bank charter would seriously impair our industry's ability to compete.

It might be helpful at the outset to give you a short history of industrial banks. They first developed in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries as small finance companies to provide loans for industrial workers. They were authorized in several states, some of which allowed them to take uninsured deposits. Utah first authorized them in 1927. Over the years, industrial banks in some states developed into depository institutions offering all the services of a bank except demand checking accounts. By the 1980s, these institutions in some states had become one among many kinds of depository charters utilized by a growing number of diversified companies in the financial services markets. When Congress enacted the Competitive Equality in Banking Act of 1987 ("CEBA"), it added language that codified this group of non-traditional bank charters. The Act made industrial banks exempt from the Bank Holding Company Act if they were chartered in states that required FDIC insurance as of March 1987.

This industrial bank exemption was retained in 1999 when Congress enacted the Gramm-Leach-Bliley Act ("GLBA"). GLBA also modified a restriction that had prevented industrial banks from allowing "interday overdrafts" on behalf of affiliates, by limiting that restriction to affiliates that engage in non-financial activities. This explicit recognition of industrial loan banks in GLBA is inconsistent with the claim that the statute was intended to prohibit affiliation between banks and non-banking entities.

The industrial banks operating in Utah today provide ample evidence of the viability of this charter. Over the past 20 years, the current generation of industrial banks has developed into one of the strongest, safest and soundest group of banks that ever existed. Group capital and

earnings are well above average. There have been no failures, even in one instance when an industrial bank's holding company became bankrupt. Industrial banks have had an exemplary record of service to their customers and the community. For example, nearly 40 percent of the Utah industrial banks examined by the FDIC for compliance with the Community Reinvestment Act has received "Outstanding" ratings, a remarkable record of achievement.

#### **Securities Firms' Ownership of Industrial Loan Banks**

The first SIA member-owned banks were organized in the 1980s. Several kinds of limited purpose charters were utilized including industrial loan banks, "non bank banks", credit card banks and federal savings banks.

Today, SIA member-firms have essentially three choices with regard to ownership of a bank:

- (1) They can operate national or commercial bank subsidiaries by divesting non-financial businesses (and non-conforming financial activities) and organize as financial holding companies under consolidated regulation by the Federal Reserve.
- (2) Firms that have federal savings bank affiliates that were grandfathered under GLBA can operate as "unitary thrift holding companies" under consolidated supervision of the Office of Thrift Supervision. Several SIA member firms fall into this category.
- (3) Firms can operate industrial banks or other limited bank charters (e.g. grandfathered "non-bank banks", credit card banks) and become "consolidated supervised entities"

examined at the holding company level by the Securities and Exchange Commission (SEC). Today securities firms predominantly utilize this option.<sup>2</sup>

Securities firms own the largest industrial banks, and collectively, control industrial loan banks that hold more than 75 percent of total industry assets and deposits.<sup>3</sup> Because securities firms typically engage in activities that are not permissible for bank holding companies, they cannot acquire full service commercial banks without exiting businesses that account for substantial segments of their revenues, which many SIA members consider critical to well-functioning capital markets. Ownership of industrial banks has therefore become the principal means of providing banking services for these firms.

Industrial banks operated by securities firms are primarily focused on two services. One is to provide better “sweep” options for individual clients with idle funds in their brokerage accounts (e.g., proceeds from dividend payments or securities sales). In the past these funds were usually swept into independent money market funds that were neither federally insured nor affiliated with the broker. The second purpose is to provide commercial lending and other banking services to securities firms’ institutional clients. Investment banking customers have increasingly demanded full service from their financial services providers, whether those providers are securities firms or commercial banks. Rather than maintaining multiple lending and securities relationships, these clients want to deal with one provider that can take care of all of their financial needs and price their services and products accordingly. To compete in this

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<sup>2</sup> A number of SIA member-firms control other types of depository institutions that, like industrial banks, may be owned by entities that are not bank holding companies (e.g., credit card banks, thrift institutions, and grandfathered “non bank banks”).

<sup>3</sup> When combined with the assets and deposits of industrial banks owned by other financial services firms, such as American Express and Advanta Corp., the financial services sector of the industrial loan bank industry comprises over 90 percent of the industry.

space, securities firms need to offer banking services and match banks' costs of funds. The best way to do that is to organize their own banks.

### **Regulation of Industrial Banks and their Owners**

With that background, let me turn now to one of the key issues in the current debate over industrial banks – the misconception that industrial banks are not adequately regulated. This is primarily linked to the fact that the Federal Reserve does not regulate industrial bank holding companies. However, a close examination of the facts confirms that both the banks and their holding companies are adequately regulated under the industrial bank model.

First, we should be clear that industrial banks themselves are fully regulated in the same manner as other banks by the same regulators applying the same laws, standards and procedures. Industrial banks cannot engage in banking activities unless they do so under the same rules as any other bank. Under the Federal Deposit Insurance Act, no industrial loan bank can engage as principal in any activity not authorized for a national bank.

The industrial bank model is actually stronger in some respects than the requirements applicable to a traditional bank. For example, because industrial banks are usually affiliated with larger diversified holding companies, there is heightened concern about compliance with Sections 23A and 23B of the Federal Reserve Act and other laws and requirements relating to affiliate transactions. To help insulate the bank from any undue influence by an affiliate, state and federal regulators impose additional requirements on an industrial bank to ensure its independence. As applied today, an industrial bank can directly or indirectly finance sales or transactions with an affiliate only if the loan is secured dollar for dollar with a dedicated cash deposit in the bank or U.S. government securities.

A Utah industrial bank is required to have independent management and boards. Boards are required to have a majority of outside directors and audit committees are required to consist solely of outside directors headed by someone qualified in auditing and accounting. Officers are required to have prior successful experience in the kinds of positions they hold in the bank. Recently regulators began to require all outside directors to have substantial prior experience in banking, accounting, regulation or another expertise relevant to the bank's business and operations. Several former Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) officials and examiners currently serve as directors and officers of industrial banks.

**Holding Company Supervision of Securities Firms with Industrial Banks by FDIC/State Regulators**

Securities firms with industrial bank subsidiaries are subject to multiple levels of holding company supervision. Like other industrial bank owners, securities firms are regulated by the FDIC and the bank's state regulator under the FDIC's "bank centric" supervisory model. Under this model, the FDIC has the following authority over the bank's parent and affiliates:

- To approve any restructuring or reorganization of the parent that affects control of the bank.
- To require production of any information and directly examine the entity.
- To issue cease and desist orders enforceable in federal court against any institution affiliated party regarding any action or activity that would threaten the safe and sound operation of the bank or violate any law, rule regulation, order or agreement.

- To impose civil money penalties on any institution-affiliated party for taking any action that violates a law, order or regulatory directive and causes any harm to the bank.

In addition, the state regulator has the following authority over an industrial bank's parent and affiliates:

- To approve any restructuring or reorganization of the parent that affects control of the bank.
- To require the production of any information and directly examine the entity.
- To issue cease and desist and remedial action orders enforceable in state court against any party in control of the bank and to impose civil money penalties for any violation of such order.
- To take possession of the bank at any time effective upon posting notice of possession anywhere on the bank's premises.

This allows the state and FDIC to oversee every action or activity of the holding company and its affiliates that is or may be pertinent to maintaining the safety and soundness of the industrial bank, the deposit insurance system itself and the payments system

In some respects, FDIC and state oversight is more effective and efficient than the Federal Reserve's regulation of a traditional bank holding company. In the case of a traditional bank holding company, regulation is divided. The bank has one group of regulators and the holding company has a different regulator. If a bank regulator has a concern about something involving a holding company or affiliate subject to the Bank Holding Company Act, the regulator must generally work through the Federal Reserve to address that problem. I can tell you from personal experience that this is not always a smooth process and the lack of coordination can be frustrating at times.

This problem does not arise with an industrial bank because the same regulators simultaneously regulate the bank and holding company. This enables the regulators to see the whole picture and take coordinated action if needed to address problems that may occur at multiple levels. The bank's regulators must approve corporate reorganizations and securities sales if they affect the bank in any way. The only substantive difference between the regulation of a traditional holding company and an industrial bank holding company is that an industrial bank's regulators don't reach into areas of the holding company and affiliates that are irrelevant to the bank.

#### **Holding Company Supervision by Securities and Exchange Commission**

All of the securities firms that operate industrial banks are also supervised at the holding company level by the Securities and Exchange Commission (SEC) as "consolidated supervised entities."<sup>4</sup>

The SEC's "Consolidated Supervised Entity" regime (17 C.F. R. Parts 200 and 240) was established by the SEC under the authority of the Securities Exchange Act of 1934. While the SEC traditionally focuses on compliance with the investor protection provisions of the securities laws by a firm's broker-dealer and other affiliates, the consolidated supervised entity structure focuses on the capital adequacy and risk management practices of holding companies.

Eligible firms (very highly capitalized holding companies) provide information to the SEC with respect to firm-wide capital, as well as market, liquidity, operational and credit risk exposure, and systems for managing these risks. Specified financial and operational information is provided to the SEC on a monthly, quarterly and annual basis, and the firm must consent to

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<sup>4</sup> SIA's membership also includes several traditional bank holding companies that operate industrial banks in addition to their commercial bank affiliates.

SEC examination of the holding company and material affiliates. SEC oversight involves both on-site examinations and ongoing communications with consolidated supervised entities. In recognition of their maintenance of mathematical models for measuring risks and group-wide systems for controlling these risks, consolidated supervised entities are permitted to use an alternative method for computing net capital, consistent with Basel II.

Consolidated supervised entity regulation was established, in part, to allow firms that do business in the European Union to comply with the requirement of the EU's "Financial Conglomerates Directive." That Directive states that firms doing business in the EU have a consolidated holding company supervisor equivalent to that applicable for their European counterparts. (A 2004 Guidance found that the SEC and Federal Reserve's holding company supervision satisfy this requirement). This is important because, while the "consolidated supervised entity" structure is a voluntary regime for U.S. firms, a firm that elected to withdraw from this supervision would become ineligible to operate in the European marketplace, a decision that is simply not an option for firms that derive very significant revenues from activities in Europe.

#### **Government Accountability Office (GAO) Report on Industrial Loan Banks**

The GAO's (GAO-05-621) report on industrial loan banks contains serious lapses and ignores important facts about the industry and should not be the basis for Congressional action. For example, the Report fails to discuss the SEC's oversight of holding companies that control the bulk of the industry's assets: the 99-page report mentions "consolidated supervised entities" just once, in a two sentence reference in the introductory segment to the report, which contains

no further discussion or analysis. This lapse would be tantamount to reporting on U.S. military preparedness without discussing the capability of the United States Marine Corps.

The GAO report's comparison of the traditional bank holding company and industrial bank regulatory models concludes that the lack of oversight over unrelated activities is dangerous and warrants terminating the "bank centric" model. Based on my 23 years of experience in this area, I can make no sense of that conclusion. Unrelated activities are truly irrelevant to protecting the bank, and I can think of no reason to devote regulatory resources to areas that do not affect the bank.

Another point the GAO missed is the inherent weakness of the traditional bank holding company model. Traditional bank holding companies do little more than own banks. They are a legal structure overlaying the banks that are organized principally to manage the bank's stock and provide other services to the bank. A traditional bank holding company rarely has substantial assets apart from the banks it owns and makes little or no contribution to the bank itself.

I was a regulator during a time when significant changes in the financial services markets resulted in a lot of overcapacity and we had to close more depository institutions than at any time since the Great Depression. During the time I was with the Department of Financial Institution's we closed a third of the banks in the state. I can recall only a few instances when the holding company made any difference in the fate of its subsidiary bank. In almost every case, the holding company had no ability to rescue the failing bank and was nothing more than a bystander.

Because of this structural weakness, the Federal Reserve can only regulate holding companies to prevent them from causing a problem for their bank subsidiaries.

In contrast, diversified holding companies can make real contributions to their bank subsidiaries. Most diversified holding companies are many times larger than their industrial bank subsidiaries and could rescue their bank from any problem up to and including a total loss of the bank's loan portfolio. Nothing in the Federal Reserve's array of powers can protect against a bank's failure better than a capital maintenance agreement with a diversified parent many times larger than the bank itself.

In addition, many diversified holding companies contribute a fully developed business to their bank. Most industrial banks are organized to add value to an existing seasoned financial services business and begin as a large and profitable business with no marketing costs. A traditional bank could achieve that level of development only after several years of operations.

Despite their obvious importance, these strengths and weaknesses were not even mentioned in the GAO report.

#### **The Role of the Financial Services Market**

The final point I would like to make is that the development of industrial banks involves much more than competition between two regulatory models. The development is driven by changes in the financial services markets over the past 20 years, some of which resulted from changes in the law but more of it marketplace driven. New technology has made it much easier to offer financial products and services and that has resulted in a proliferation of both sources and kinds of credit throughout the economy. Businesses of every kind increasingly offer financial services. It may be the case that companies operating outside the traditional bank holding company structure provide most of the credit in the economy today. This expansion of credit has played a central role in the growth of the economy.

This is why I find it baffling that proponents of walling off traditional banks from competition continue to win supporters. Congress has already decided that restrictions against affiliations between banks and securities firms or insurance companies can be safely lifted, and banking-securities affiliations have operated without incident under both the bank holding company model and the industrial bank model. What sense does make to prevent other affiliations that can enhance credit availability without impairing the safety and of banks?

Until about 20 years ago, banks were the primary sources of credit and it was important to segregate them from other businesses so everyone had equal access to credit. Today, that is no longer necessary because there are so many diverse sources of credit. This has removed the risk of a credit concentration and replaced it with an array of legitimate companies providing high quality and high demand financial services. Many of those companies increasingly request access to a depository charter because it will enable them to operate their business more efficiently and cost effectively. Industrial banks have grown over the past 20 years primarily because they are an outlet for this growing market pressure.

There is simply no evidence that a company engaging in activities other than banking presents any safety and soundness risk to an affiliated bank. Financial services are a natural and logical choice for most businesses today. Many industrial banks offer financial services that they or their affiliates invented and are more proficient in providing than anyone else. For some companies, moving a financial services business into a bank is necessary to survive. For others, offering financial services is an opportunity to expand and deepen their customer relationships. This growing market trend cannot be legislated away and there is no good reason to oppose it. This conflict between the market and outdated provisions in the Bank Holding Company Act is the real issue underlying the controversy over industrial banks and banking commerce.

One thing I learned as a regulator is that the regulatory system serves the market and does not work well if the two are mismatched. This conflict between the market and the Bank Holding Company Act must be resolved before the current controversy will end. Repealing the exemption for industrial banks is not a solution. That would only cause the market pressures to grow until they find another outlet or finally induce Congress to repeal the Bank Holding Company Act limitations altogether.

How the different regulatory models fit with the markets is another glaring omission in the GAO report. In my view, that is its biggest flaw. No proper study of a regulatory structure could be made without reviewing in depth how it meshes with the industry it regulates and the markets it serves. The GAO study did not even mention the financial services industry or markets. It didn't assess why so many diversified companies want access to a depository charter or study market trends. Without that, the study was effectively blind.

### **Conclusion**

I hope the information provided to the subcommittee today will clarify at least some of the misinformation and misunderstanding that has infected the debate about industrial banks during the past few years. The facts are simple:

- Industrial banks pose no unusual safety and soundness risk. The industry has developed into one of the strongest and safest group of banks that ever existed.
- The regulation of the industrial banks is comparable to, and in some respects stronger than, the regulation of all other banks.

- There is also extensive and effective regulation of the holding companies and affiliates. That regulation is performed by the SEC and concurrently by the banks' regulators and is more unified and coordinated than the divided regulation of traditional banks and their holding companies.
- Finally, there is nothing unusually risky about the market forces prompting the development of the industrial bank industry. Companies of every kind increasingly offer financial services, some because it is an opportunity to deepen and diversify existing customer relationships, others because of the necessity to meet customer demand and compete effectively. This development is natural and logical and has produced a broad array of companies engaged in many diverse and completely legitimate activities that want access to a depository charter because it enables them to provide their financial services more efficiently and cost effectively.

To be effective, the regulatory system must adapt to these changes. Allowing industrial banks to continue to serve the needs of the market is a proven and prudent way to accomplish that goal.

Testimony of  
Lawrence J. White  
at the Hearing on  
“ILCs – A Review of Charter, Ownership, and Supervision Issues”  
Subcommittee on Financial Institutions and Consumer Credit  
Committee on Financial Services  
U.S. House of Representatives  
July 12, 2006

I am pleased and honored to have this opportunity to testify before this Subcommittee on today's important topic. In the pages that follow, I will lay out a principled policy approach<sup>1</sup> that the U.S. regulatory system for banks and other depository institutions<sup>2</sup> should follow in considering matters such as the whether non-financial companies should be allowed to own depository institutions, including industrial loan corporations (ILCs).

This approach uses the concept of "examinable and supervisable" to delimit the activities that should be allowable for a bank. All other activities that are otherwise legal should be permitted for the owner of a bank (including a bank holding company), so long as the activities occur outside of the bank and the direct and indirect financial relationships and transactions between the bank and its owner are closely scrutinized.

The logical implication of this approach is that any party that is otherwise qualified (e.g., is financially capable, has a sound business plan, and is of sound character) should be allowed to own a bank, so long as the bank itself is adequately capitalized and competently managed and the activities

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\* Stern School of Business, New York University, 44 West 4th Street, New York, NY 10012-1126; tel: 212-998-0880; e-mail: Lwhite@stern.nyu.edu. This statement represents solely my own views and is not made on behalf of any organization. During 1986-1989 I was a board member of the Federal Home Loan Bank Board.

<sup>1</sup> Greater detail and support for the positions advanced in this statement can be found in the books and articles that are cited at the end of this statement.

<sup>2</sup> In this statement, unless I indicate otherwise, the term "banks" broadly covers all depository institutions.

of the bank (and its relationships and transactions with its owner) adhere to the delimitations just described.

Accordingly, I believe that the ownership of ILCs by non-financial companies represents a sensible direction for public policy. Indeed, I believe that banking charters generally, whether state or national, should be expanded so that non-financial companies can readily own banks, subject to the limitations that I have described. If it is the Congress's judgment that the Federal Deposit Insurance Corporation (FDIC) and other bank regulators do not have the authority or capabilities to conduct the monitoring of the financial relationships between the parent/owner and the bank that is necessary, then the Congress should pass legislation that would give the regulators this authority and/or the resources to develop the capabilities -- rather than preventing these potentially productive ownership arrangements.

As a related matter and following the same logic, I believe that banks or bank holding companies should be allowed to enter the business of real estate brokerage.

The rest of this statement will expand on these ideas.

#### I. The Rationale for Safety-and-Soundness Regulation of Banks.

Banks are special. That concept lies at the center of why banks are subject to a special kind of government regulation: safety-and-soundness regulation.

Banks' specialness generally arises from their generic combination of assets and liabilities: relatively illiquid assets (usually loans) and highly liquid liabilities (deposits). This combination makes banks potentially vulnerable to rapid withdrawals of depositors' funds: "runs". In addition, banks are at the center of the economy's payments system, so they have constant creditor-borrower relationships among themselves, leaving banks exposed to potential losses (and preemptive runs) at each other's hands.

Liability holders generally worry about a corporation's losses because of the legal principle

of limited liability: Once a company's losses have exhausted its owners' equity (or net worth), the owners are generally no longer liable for any further losses, which will have to be absorbed by the liability holders. Though this a general problem that extends to the creditors of all corporations (who then try to protect themselves through covenants and lending restrictions), it is a special problem for banks, for at least three reasons:

First, some bank depositors may be relatively unsophisticated, poorly informed, and in a poor position to protect themselves against the losses from a bank's insolvency; also, banks tend to be more opaque (and thus more difficult to be informed about) than are other enterprises.

Second, and related to the first, banks are especially vulnerable to runs by imperfectly informed depositors -- or even by informed depositors who fear runs by imperfectly informed depositors.

Third, and building on the first two, there may be a "contagion" effect, whereby imperfectly informed depositors of one bank, seeing a run on another bank, may fear for the solvency of their own bank (or may just fear that other depositors of their own bank will become fearful and begin to withdraw). Alternatively, since banks are frequently in the position of being a short-term lender or borrower vis-a-vis other banks, the insolvency of one bank may set off a cascade of insolvencies of other creditor banks (or may cause a contagion of runs by banks-as-creditors who have imperfect information and fear insolvency).

## II. The Response: Safety-and-Soundness Regulation.

Some version of these scenarios (plus, historically, the perceived position of banks as special lenders) has caused the American polity -- since the early nineteenth century -- to treat banks as special and to develop special regulatory regimes to deal with their specialness. At the center of such regimes have been efforts to maintain banks' solvency, so that the value of their assets remains greater than the value of their liabilities -- to keep them "safe and sound". Since 1933 federal deposit

insurance has provided an additional layer of assurance (and thus an additional damper on potential runs) by protecting depositors against regulatory failure.<sup>3</sup>

At the heart of safety-and-soundness regulation are four key components: (a) minimum capital (approximately, net worth) requirements, to keep banks solvent;<sup>4</sup> (b) limitations on activities, to prevent excessive risk-taking;<sup>5</sup> (c) management competency requirements, to prevent inadvertent insolvencies; and (d) in-the-field examiners and supervisors, to enforce the rules.

### III. What Activities Are Appropriate for a Bank?

As the previous section indicated, limitations on banks' activities are one of the key components of safety-and-soundness regulation, as part of the effort to limit banks' risk-taking (since the "downside" from risk-taking will usually be bank losses).

But what limitations on banks' activities make sense? The logic of safety-and-soundness regulation has an immediate implication: The only activities that are appropriate for a bank are those that are "examinable and supervisable": those for which regulators are capable of assessing risks and of setting commensurate capital requirements and also for which the regulators can make judgments about the competence of the bank's management of the activity. This examinable-and-supervisable decision ought to be a regulatory judgment, but the political appointees heading the regulatory agency should be held accountable for those judgments.

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<sup>3</sup> In an important sense, with deposit insurance in place, safety-and-soundness regulation becomes the rules that protect the deposit insurer (as well as uninsured depositors and other creditors).

<sup>4</sup> Capital plays two important roles: First, it is a direct indicator of a bank's solvency -- the buffer of protection for depositors against a fall in the value of the bank's assets. Second, since capital is essentially the owners' equity, it provides a disincentive for the bank's owners to take risks.

<sup>5</sup> Activities mean broadly all kinds of assets, liabilities, or ongoing business operations of a bank.

#### IV. What Activities Are Appropriate for a Bank's Owners?

Any activity that is not appropriate for a bank (because regulators are unable to set capital requirements and/or to judge managerial competence with respect to the activity) should nevertheless be permitted for the bank's owners, regardless of whether the owners are individuals, a corporation, or a bank holding company.<sup>6</sup> However, it is crucial that all transactions between the bank and its owners (or subsidiaries of the owners, or friends and associates of the owners) must be closely monitored by regulators, because it is relatively easy for funds to be siphoned out of a bank (and thus leave the bank insolvent): The bank can pay excessive dividends to its owners; or it can undercharge for the services that it provides to its owners (e.g., it can extend loans to owners at concessional interest rates or that simply do not get repaid); or it can overpay for goods or services bought from its owners.<sup>7</sup>

In essence, any direct or indirect transactions between the banks and its owners and affiliates must be on arm's-length terms and monitored closely by regulators, and penalties for violations must be severe. This is the logic that sensibly underlies Sections 23A and 23B of the Federal Reserve Act.

A stylized way of portraying the appropriate locations for activities and the need for monitoring is provided in Figure 1.

#### V. Some Examples.

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<sup>6</sup> The location of the (non-examinable-or-supervisable) activity -- whether it is lodged directly with the owners (or the bank holding company) or in a separate subsidiary of the owners or a subsidiary of the bank (so long as that subsidiary is separately capitalized -- i.e., the subsidiary's net worth does not count as an asset for the bank) -- is much less important than its exclusion from the bank itself.

<sup>7</sup> The risks of siphoning funds out of the bank through undercharging or overpaying also apply to transactions with associates or friends of the owners, who may in turn provide the owners with commensurate compensation or favors.

As a practical matter, it is clear that loans and loan-like products -- commercial loans, personal loans (including credit card debt), real estate mortgages, etc. -- are highly likely to be deemed appropriate for a bank. Regulators are familiar with them and believe that they can set appropriate capital requirements and judge managerial competence with respect to loans.

At the other extreme, suppose that the XYZ National Bank wants to own and operate a delicatessen. In principle, the Office of the Comptroller of the Currency (OCC) could probably hire restaurant consultants who could advise the OCC on how to judge XYZ's managerial competency in running a delicatessen and what an appropriate capital requirement for owning a delicatessen should be. In practice, it is more likely that the OCC would decide that this is not an area in which it has (or wants to acquire) expertise, and therefore running a delicatessen is not an activity that would be appropriate for a national bank.

However, there is no principled reason to prevent the owners of the XYZ National Bank -- whether as individuals, or as a bank holding company -- from owning and operating a delicatessen. But the relationships and transactions between the bank and the delicatessen need to be on arm's-length terms and would need to be tightly monitored by the OCC, to make sure that these transactions do not become a vehicle for siphoning funds out of the bank and into the pockets of the owners -- e.g., the OCC needs to make sure that the bank does not make under-priced (or hopelessly unrealistic) loans to the deli and/or that the bank does not buy over-priced pastrami sandwiches from the deli for the bank's employees' lunches.

And, of course, the same concepts should apply to the bank owners' operation of any kind of business, regardless of whether that business is a software company, an automobile dealership, an airline, or a forestry company.

It is worth noting that there has been an extensive history of non-financial firms owning savings and loan institutions, through a unitary thrift holding company arrangement, with few problems arising as a consequence.

VI. The Implications.

The implications of the approach that has been outlined above are clear: Any party that is otherwise qualified (e.g., is financially capable, has a sound business plan, and is of good character) should be allowed to own a bank, so long as the bank is adequately capitalized and competently managed, the activities of the bank are restricted to those that are examinable and supervisable, and the relationships and transactions between the bank and the owner are closely monitored by bank regulators.

Consequently, with respect to ILCs, so long as the state that has chartered an ILC and the FDIC can do a good job of monitoring the financial relationships between the parent and the ILC, along the lines described above, ILCs represent a sensible direction for public policy. Indeed, I believe that bank charters generally should be expanded so as to allow non-financial companies to own banks, subject to the restrictions that I have described above.

If it is the Congress's judgment that the FDIC and other bank regulators do not have adequate authority or sufficient capabilities to monitor banks (including ILCs) and their owner/parents in the way that I have described, then enacting legislation to provide the regulators with the necessary authority and/or the resources to develop the needed capabilities is the best response -- rather than to prevent these potentially productive ownership arrangements.

As a related matter: It has been suggested by some parties (e.g., the National Association of Realtors) that the issue of non-financial companies' being granted a banking charter and the issue of banks' being allowed to enter the real estate brokerage business are intertwined. They are correct, as a general matter. Both issues raise the general points that are discussed above. And both should be addressed in the same way: Non-financial companies should be granted bank charters, subject to the conditions just described; and, as a matter of policy, banks -- or at least bank holding companies -- should be allowed to enter the real estate brokerage business (with the distinction between whether

banks directly or only bank holding companies are permitted to undertake real estate brokerage, of course, hinging on whether real estate brokerage activities are considered examinable and supervisable by bank regulators).

#### VII. The Wal-Mart Application and "Unfair Competition"

It is surely no secret that the event that has drawn such extensive public attention to the existence of ILC charters has been Wal-Mart's application to obtain a Utah ILC charter and FDIC deposit insurance for its ILC. Because that application is the "900 pound gorilla in the room", it is worth addressing the Wal-Mart issues directly rather than pretending that they are not important for the ILC question.

The Wal-Mart application has drawn a great deal of attention because of Wal-Mart's success and expansion in general retailing. The opposition and fears do not primarily concern the issues of safety and soundness that have been addressed above. Instead, rival bankers fear that a Wal-Mart Bank may expand at their expense, perhaps with the financial help of the parent; rival retailers fear that a successful Wal-Mart Bank will supplant rival banks and reduce the retailers' supply of credit and thereby disadvantage the retailers. Neither set of fears is likely to translate into a realistic scenario.

First, as is well known, Wal-Mart currently plans to use its bank exclusively as a way of reducing its "back office" financial transactions costs. This use surely cannot generate any of the feared scenarios.

But let us grant Wal-Mart's rivals' worst-case scenario in terms of Wal-Mart's subsequent bank expansions: that Wal-Mart expands its banking operations so as to attract retail customers -- say, through opening retail branches in its stores, and it even opens free standing-branches. What then?

If this is a convenient and efficient arrangement for Wal-Mart and for shoppers, then they

will become bank customers. Rival banks will lose some customers. Some rivals may be unable to compete effectively and will seek merger partners; others will devise new strategies to attract and retain customers.

Will a successful Wal-Mart Bank sweep the countryside clean of all rivals, and will Wal-Mart's retailing rivals thereby be deprived of finance and consequently be at a disadvantage? This seems highly unlikely. The executives of small banks have a history of claiming dire consequences every time a state legislature contemplated allowing expanded intra-state branching privileges during the 1960s, 1970s, and 1980s, and again as the Congress contemplated permitting nationwide branching in the 1980s and 1990s. And, yet, despite today's near ubiquitous nationwide branching possibilities and over two decades of active mergers and banking consolidation, there are still (as of year-end 2005) over 7,500 commercial banks chartered in the U.S., as well as over 1,300 savings institutions and over 8,500 credit unions. Further, despite the consolidation, thousands of new (*de novo*) banks have been formed over the past few decades, as enterprising bankers have seen and embraced new business opportunities, often in the wake of mergers. Existing banks have extended their branch networks as well. A similar pattern could be expected if an expanded Wal-Mart bank were to leave the financial needs of groups of customers unfulfilled.

America's bankers may not like the competition; but they are creative and resourceful, and most will survive.

Might the parent Wal-Mart subsidize the bank so as to allow the bank to behave in a predatory manner and eliminate financial rivals? First, note that the parent subsidizing the bank is the exact opposite of the usual scenario -- that the parent might try to drain funds *out of the bank* -- that should worry bank regulators. Second, for predatory behavior to be ultimately successful and profitable, the initial period of subsidized behavior must be followed by a "recoupment" period when monopoly profits can be achieved. But if bank charters remain readily available for *de novo* entrants and branch extensions remain easy to achieve for incumbents, such recoupment is unlikely, which

should discourage any initial attempts at predatory behavior. And third, the U.S. antitrust laws remain as a policy tool for dealing with predatory behavior.

Might Wal-Mart "lean" on its suppliers to use the Wal-Mart Bank as a condition for being allowed to sell their goods in Wal-Mart stores? If the Wal-Mart Bank's terms are otherwise not as favorable for the supplier as the latter's original bank, then Wal-Mart will have to give up something else -- perhaps Wal-Mart will have to accept a higher wholesale price when buying the supplier's goods. And, as a consequence of such "leaning", Wal-Mart's retailing rivals would be that much more attractive to the suppliers as outlets for their goods. Also, such conditioning would bring Wal-Mart under antitrust scrutiny for "tying".

Much of this discussion, and the fears expressed, has the same flavor as those expressed by the securities industry in the 1970s, 1980s, and 1990s, as it opposed the gradual breaking down of the Glass-Steagall barriers that had separated the commercial banking industry from the securities industry since the 1930s. Those fears -- that banks would somehow behave in a predatory fashion toward the securities industry, that banks would somehow decimate and dominate the securities industry, and/or that entrance into the securities industry would somehow weaken the safety and soundness of banks -- all proved to be unfounded. The same would likely be true of the scenarios advanced by Wal-Mart's foes.

In sum, the "doomsday" scenarios of Wal-Mart's rivals seem far-fetched and unrealistic. Such scenarios ought not to be guiding bank regulatory policy.

#### VIII. Conclusion.

In this statement I have offered a principles-based policy approach to what activities should be permitted for a bank, what activities should be permitted outside of a bank, who should be allowed to own a bank, and how the relationships and transactions between a bank and its owner should be structured and monitored.

This approach has a clear implication for the subject of today's hearing: So long as ILCs are adequately examined and supervised, they represent a sensible direction for public policy. Indeed, bank charters generally should be expanded so as to allow non-financial companies to own depository institutions, subject to the conditions that I have described above. And if the Congress judges that bank regulatory authority or capabilities are not adequate for the job, then the Congress should enact legislation that would strengthen that authority and/or those capabilities – rather than restricting potentially productive ownership arrangements.

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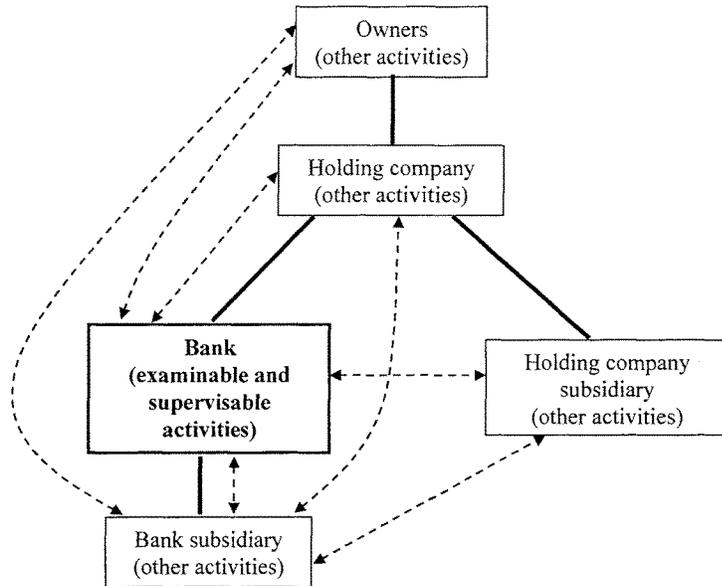
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Figure 1: Stylized Structure of Locations of Appropriate Activities for a Bank and of Other Activities



— Lines of ownership  
 <--> Transactions to be closely monitored

**TESTIMONY OF MICHAEL J. WILSON**  
**INTERNATIONAL VICE PRESIDENT AND DIRECTOR,**  
**LEGISLATIVE AND POLITICAL ACTION DEPARTMENT,**  
**UNITED FOOD AND COMMERCIAL WORKERS INTERNATIONAL UNION**

**Before the**

**FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE OF THE**  
**HOUSE FINANCIAL SERVICES COMMITTEE**

**ILCS—A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES**

**July 12, 2006**

Thank you Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee for holding this hearing and for the opportunity to testify. I am here today representing the United Food and Commercial Workers International Union. With 1.4 million members in the United States and Canada, the UFCW represents workers in every state in the United States. UFCW members work in grocery stores and in the meatpacking and food processing sectors where they work to put dinner on the table for America's families. Thousands of other UFCW members also work in the health care industry, in the chemical industry, in department stores, in garment manufacturing, in the production of distillery products as well as textile trades.

The topic of ILCs and their regulation has been of great concern to our membership for several years. If ILCs are not properly regulated – and we believe that today they are not – our members may be at risk. The list of risks is long, including everything from reduced consumer protections to insolvency, which can directly impact our members.

Page 2

When commercial companies look to establish banks there are specific problems that are potentially troubling. The trend we are seeing today is somewhat reminiscent of an earlier era in American history – an era in which the company town was prevalent. These company towns were places where workers were dependent on a single company not just for their job, but for their housing, for their health care, and for most of their retail needs. Many of the companies that ran these towns developed a track record of unsafe working conditions and abusive dealings with employees on everything from the wages they paid to the amounts they charged for basic staples to usurious interest rates. These abuses included practices such as underpaying workers by falsely reporting the amount those workers produced. What our country learned was that if a company is too powerful and people have to rely on it for too many things – the imbalance of power almost inevitably leads to abuses.

The record push of commercial companies looking to get into the banking industry through this obscure ILC loophole should remind us all of this lesson. The policy in the United States has long been to explicitly keep banking and commerce separate. That has proven to be sound economic policy and it has benefited consumers and workers who might otherwise find themselves at the mercy of a single large firm for too many of the goods and services they need. It has also provided for a vibrant and competitive financial services industry that offers many products and services to consumers. The fact that so many commercial firms are now trying to circumvent this basic policy through a loophole in the law is troubling. We should not allow decades of good policy to be undone through an inadvertent backdoor mechanism.

We recognized the potential problem with the ILC loophole years ago and were one of the founding members of a diverse group of organizations known as the Sound Banking Coalition. I would note that the Sound Banking Coalition was created early in 2003 when there were few commercial applicants for ILC charters. In fact, even Wal-Mart did not have an application for an ILC outstanding at that time.

Wal-Mart, of course, looms large over the present ILC debate. Given their size – and the fact that they are the largest corporation in the country – that may be quite appropriate. It is absolutely certain that if Wal-Mart gets a bank through a loophole in the law, the loophole will be larger than the rule. And we are seeing that Wal-Mart is forging a path that many other commercial firms are intending to follow. There are now a record number of commercial companies applying to get ILCs. Blue Cross/Blue Shield, Home Depot, Berkshire Hathway – these and more are following Wal-Mart's lead. Congress should deal with the policy questions here before corporations looking to add financial services as another business line – along with home repair or health care – making Congressional policymaking an afterthought. Wal-Mart has a contradictory impact on the debate about ILCs. Its size and reputation helps to illuminate the arcane world of regulating financial institutions and brings many non-financial interests to the discussion. Simply witness the nearly fifty local, state and national institutions, individuals and organizations who testified at the FDIC's recent (and unprecedented) public hearings on this very application. However, at its heart, this is not a debate about a single company, but about federal policy regarding ILCs, and how regulators and Members of Congress can provide security and sound policymaking to our nation. That is the matter before us today, and to which I will address my testimony.

One of the issues that must be addressed is consolidated supervision of banks at the holding company level. That esoteric but important concept is tremendously important. Holding companies that own banks in this country are subject to regulation by the Federal Reserve Board. The Fed reviews these companies and all of their subsidiaries to ensure that the holding company and the subs do not create solvency risks for the bank. In fact, the holding company is supposed to be a source of financial strength for the bank – that can be helpful if things do not go well. The Fed regulates these holding companies whether the bank itself is a state-chartered bank or a national bank. Foreign bank owners can be an exception to this rule, but only if those foreign firms are subject to similar, consolidated supervision in their home countries. Why

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should we be such sticklers about this type of regulation in the banking world? The reason is that we have seen bank failures in the past. The savings and loan scandal is one example, but there are many others. When banks fail we all get hurt – and we can all end up paying for it. We are far better off when there is a regulatory agency which is able to look at the entire holding company and address any problems before they become too big to solve. The savings of real people and real businesses are in these institutions and it is appropriate that we take seriously our obligation to protect people's money.

That should not be any less true when the type of bank we are talking about is an ILC. Our obligation to protect people's funds should be the same – the accounts are, after all, protected by the same FDIC insurance. And the problems with a failure can be just as devastating. During the savings and loan crisis, no one who lost money was comforted by the fact that the institution that failed was called an S&L rather than a bank. Calling something an ILC should not change the policy. If consolidated supervision is needed for other banks – and we believe that it is – then it is needed for ILCs.

The other key concept that is tremendously important here – even if it may seem just as boring as consolidated supervision – is the mixing of banking and commerce. Banks are supposed to be neutral arbiters of financing and, if those banks are owned by commercial companies, the conflicts of interest can skew loan decisions and lead to systemic problems. Banks are also an important source of economic opportunity. For individuals who need a loan – including starting and expanding a business – a bank is typically the first place to start. If local banks disappear the way we have seen local commercial businesses disappear in recent years, we are all in for a rude awakening.

This is a large reason of why Wal-Mart's application in particular is such a threat, and why it appears to be a harbinger of more. We have watched Wal-Mart come into town after town and impact Main Street, business by business. Studies have documented the impact on employment, wages, benefits, and tax revenue. One of the areas least affected directly – thus far – are financial services, where access to capital

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and credit offer lifelines in many communities. Local community banks and other financial institutions are critical to economic vitality and diversity. If the capital is there, then new businesses can spring up, and the ones that may still be hanging on can reinvent themselves and find ways to compete. If there is no local source of capital, however, that community is on life support until a large multinational retail chain headquartered in Arkansas makes a decision about that local community. And they know just how to do it by closing locations and opening regional "superstores."

Of course, if Wal-Mart can get a bank and push local banks out of more of these communities, its economic control in these local communities will be almost complete. Just like with the company towns of the past, there will be few options for people to stand up to the sole source of economic power in the community. A regulator in Utah cannot protect against this danger and weighing the impact on local communities in distant states should not be its job.

So, what should be done? The first thing is that Congress must act. Fundamental policy decisions should not be set aside simply because it is difficult to fix this loophole. And we should not let the economic interests of one state dictate structural problems in our nationwide system of banking regulation. With the increasing use of Internet banking, ATMs, and banking by phone, this would mean that more and more one state would be setting the banking rules for all the rest of us. Governors and state legislatures have recognized this and at least five of them – Iowa, Maryland, Vermont, Virginia, and Wisconsin – have already enacted new laws to keep ILCs from branching into their states. More states are poised to act, and we are engaged in active discussions encouraging states, in the absence of federal legislative activity, to take appropriate steps. But states should not be forced to create a piece-meal approach to deal with an issue that can be – and should be – addressed by the Congress. In fact, Representatives Paul Gillmor of Ohio and Barney Frank of Massachusetts have just introduced the Industrial Bank Holding Company Act of 2006 to address this problem. We believe that this is a good step in the right direction and that legislation would help address the problems I have described for commercial ILCs.

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I urge you to consider the Gillmor-Frank legislation and to enact it to address the problems and challenges outlined in my testimony. The members of the UFCW do not want to reside in a "company town." We seek to live in a nation of laws and of opportunity. Again, I thank you for your time and would be pleased to attempt to answer any questions that you may have.



Office of Thrift Supervision  
Department of the Treasury

John M. Reich  
Director

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

July 11, 2006

The Honorable Spencer Bachus  
Chairman  
Subcommittee on Financial Institutions  
and Consumer Credit  
Committee on Financial Services  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

As you evaluate the structure and supervision of the industrial loan company (ILC) segment of the financial services industry, it is important to clarify the Office of Thrift Supervision's (OTS) existing supervisory authority in this area.

Some have suggested that ILC's and their holding companies are unregulated and that ILC's in holding company structures pose potential risks arising out of the relationship, transactions and activities between the ILC and its parent holding company. It has been further suggested that these risks may only be managed by subjecting the corporate parent of an ILC to supervision as though it were a bank holding company. In fact, there is a regulatory structure already in place in which a number of ILC holding companies are currently subject to holding company oversight.

In any instance where an ILC and a savings association are affiliated in a corporate structure, the holding company is a savings and loan holding company subject to regulation by the OTS. In such cases, the state is the primary regulator of the ILC, the FDIC is the appropriate federal banking agency for the ILC, and the OTS is the appropriate federal banking agency for the ILC holding company, as well as the affiliate savings association.

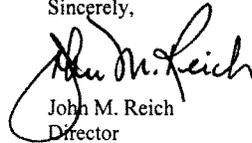
The notion that only a bank holding company framework provides rigorous holding company oversight is mistaken. The OTS has long exercised broad and effective oversight of complex holding company structures that own savings associations. OTS currently supervises 481 thrift holding companies with aggregate assets of \$7.5 trillion. Eight of these companies also own an ILC and, as such, are subject to OTS holding company jurisdiction and oversight. These OTS-supervised holding companies control approximately 70 percent of the total ILC assets nationwide, and include Merrill Lynch, Morgan Stanley, USAA, American Express, Lehman Brothers and General Electric.

Page 2

Authority for OTS to supervise these depository holding company structures under the Home Owners Loan Act is comprehensive. This authority is recognized not only domestically, but also internationally by the European Union, which has recognized OTS as a consolidated coordinating supervisor for General Electric, an OTS-supervised holding company conglomerate that operates in the EU.

As you consider legislation involving oversight of the ILC industry, please feel free to contact us with any questions you may have with respect to OTS's experience, holding company supervisory authority and oversight. My staff and I are also available to assist you in any manner regarding legislation in this area. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "John M. Reich". The signature is fluid and cursive, with the first name "John" being particularly prominent.

John M. Reich  
Director

cc: Members of the Subcommittee on  
Financial Institutions and Consumer Credit



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Executive Director,  
Congressional Affairs and  
Public Policy  
Phone: 202-663-5339  
Fax: 202-828-4548  
[fstoner@aba.com](mailto:fstoner@aba.com)

July 11, 2006

The Honorable Paul Gillmor  
U.S. House of Representatives  
1203 Longworth House Office Building  
Washington, DC 20515

The Honorable Barney Frank  
U.S. House of Representatives  
2252 Rayburn House Office Building  
Washington, DC 20515

Dear Representatives Gillmor and Frank:

On behalf of the members of the American Bankers Association (ABA), I am writing to express our strong support for H.R. 5746, the "Industrial Bank Holding Company Act of 2006." ABA urges Congress to enact this legislation quickly.

The most important aspect of this bill is the effective elimination of the authority in current law that allows a commercial company to acquire an insured depository, i.e., an industrial loan company (ILC). The ABA opposes the acquisition or chartering of banks by non-financial commercial firms. By prohibiting new commercial companies from obtaining ILCs, H.R. 5746 would eliminate this mechanism for the merging of banking and commerce.

H.R. 5746 would likewise establish a number of other important regulatory guidelines with respect to ILC operations. It establishes a bright-line test with respect to who may own ILCs in the future, limiting ownership to those parent companies that are truly "financial." It creates a significant Federal regulatory supervisory presence over ILC parent company operations, broadly empowering the Federal Deposit Insurance Corporation (FDIC) to act in this area. The bill establishes appropriate restrictions on grandfathered ILC operations, limiting the ability to transfer ownership of these ILCs to new commercial companies, and, in some instances, the ability to branch or engage in new activities. The ABA sees these provisions as important clarifications to existing law that, consistent with previous congressional efforts addressing the banking and commerce question, appropriately resolve regulatory concerns while recognizing the interests of those who are currently lawfully engaged in ILC operations.

The ABA strongly supports H.R. 5746, appreciates your leadership in this area, and pledges to work aggressively in support of the bill's quick passage.

Sincerely,

A handwritten signature in black ink that reads "Floyd E. Stoner". The signature is written in a cursive style with a prominent flourish at the end.

Floyd E. Stoner



July 11, 2006

The Honorable Paul Gillmor  
U.S. House of Representatives  
1203 Longworth HOB  
Washington, DC 20515

The Honorable Barney Frank  
U.S. House of Representatives  
2252 Rayburn HOB  
Washington, DC 20515

Dear Congressmen:

I am writing to express ACB's support for "The Industrial Bank Holding Company Act of 2006." This legislation will establish statutory requirements for certain state banking charters concerning the mixing of banking and commerce. These requirements are a logical extension of principles established by Congress under the Gramm-Leach-Bliley Act (GLBA) in 1999, will bring parity to the banking system and reduce potential risks to our nation's financial system.

When Congress passed GLBA it did not address the issue of allowing industrial loan companies (ILCs) as a form of charter by which commercial entities could enter the banking business. Your legislation, "The Industrial Bank Holding Company Act," solves this problem by creating a common sense system of regulation for ILCs by creating an ILC holding company structure that provides the FDIC with the authority to examine the entire ILC holding company for safety and soundness.

In addition, your legislation treats those ILCs that have already been lawfully created to retain their current structure, with reasonable limitations for the newer ILCs created in the past few years, but prohibits future ownership of ILCs by commercial firms. This is a fair method to ensure the safety and soundness of our nation's financial system without punishing those ILCs that were lawfully established, and is substantially similar to procedures implemented under GLBA.

Thank you for your leadership on this bill. ACB applauds your hard work in drafting the "Industrial Bank Holding Company Act." We look forward to working with you to bring about its swift consideration.

Sincerely

A handwritten signature in dark ink that reads "Robert R. Davis". The signature is written in a cursive style.

Robert R. Davis  
Executive Vice President and  
Managing Director, Government Relations

cc: The Honorable Michael Oxley

CONSUMER FINANCE LAW

# QUARTERLY REPORT

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## Industrial Banks

By George Sutton



George Sutton is an attorney at the firm of Callister, Nebeker & McCullough in Salt Lake City, Utah, where he is head of the Banking and Finance Group. His practice specializes in regulation of financial services companies and consumer credit. He served as the Utah Commissioner of Financial Institutions from 1987 to 1992, where he was responsible for regulating all state chartered depository institutions and all consumer financial services providers in Utah. In 1984 he helped draft and enact the Utah Consumer Credit Code and has been involved in drafting other Utah laws affecting banks, mortgage companies, and financial services generally.

### I. Introduction

An "industrial bank" or "industrial loan company" (industrial bank) as described in this article is a state-chartered bank that is eligible for FDIC deposit insurance and is exempt from the definition of "bank" in the Bank Holding Company Act (BHCA).<sup>1</sup> Industrial banks with all these characteristics can only be chartered in Utah, Colorado and California.<sup>2</sup>

The primary advantages of an industrial bank are:

- It has the same ability as any other federally-insured depository institution to "export" its home state's laws regarding interest and finance charges regardless of where its customer resides.
- It can offer a full range of deposits including certificates of deposit in any denomination and negotiable orders of withdrawal, or NOW accounts, but not commercial checking accounts if it has more than \$100 million in assets or was acquired by its current owner after March, 1987.
- It can offer a full range of loans and other financial services to both consumer and commercial customers.
- It can be an original issuer of Visa or MasterCard credit and debit cards, including business cards.
- It can fund its operations with deposits and Federal Home Loan Bank (FHLB) borrowings.
- There is no restriction on other products and services that can

be offered by a holding company or any affiliate of an industrial bank.

- The holding company and its nonbank subsidiaries are not regulated by the Federal Reserve Board (FRB) under the BHCA but are regulated by the state banking commissioner and the bank's primary federal regulator under generally less intrusive laws and regulations. Ongoing regulation primarily covers affiliate transactions, safe and sound operations, and the ability to provide financial support to the bank. Industrial bank holding companies are not subject to minimum requirements for capital like a bank holding company or a financial holding company.
- An industrial bank holding company is not subject to the penalties applicable to a financial holding company if a subsidiary bank suffers a capital impairment or receives a less than satisfactory Community Reinvestment Act (CRA) rating.

The primary disadvantages of an industrial bank are:

- Inability to offer commercial checking accounts.
- Uncertain ability to exercise some rights and privileges of a national bank or federal savings bank, such as use of a debt cancellation clause in loan contracts.

2. (Continued from previous column)

useful for the purposes described in this article. Most of those statutes have been repealed or merged in the commercial banking statutes (Hawaii and Michigan). A small number of other states provide for chartering industrial banks but those institutions are not eligible for federal deposit insurance or do not qualify for the exemption from the Bank Holding Company Act (Nevada).

1. 12 U.S.C. § 1841(e)(2)(H).

2. Many other states have or had statutes providing for chartering of industrial loan corporations but none of those charters are (Continued in next column)

## II. Structure of an Industrial Bank

Each industrial bank is chartered and regulated by the state banking commissioner in the state where the institution is based. Virtually all industrial banks organized in the past several years are based in Utah. Each industrial bank also has a primary federal regulator which can be either the FDIC or the FRB. As of now, all industrial banks in Utah have elected to be nonmember banks regulated by the FDIC.

Industrial banks are subject to the same regulations and regulatory standards as any FDIC-insured commercial bank, including the Community Reinvestment Act (CRA), sections 23A and 23B of the Federal Reserve Act, and FRB Regulation O. With limited exceptions, industrial banks can only make direct investments and engage in other activities authorized for a national bank. Both industrial banks and their holding companies are subject to all tying restrictions set forth in the BHCA.

The typical industrial bank is owned by a parent corporation with well established multistate operations. Most industrial banks offer specific financial products and services to established customers of the parent or affiliates across the nation. The primary force driving the industry is the opportunity to leverage existing customer relationships and put more products and services through established distribution channels. Large increases in productivity and economies of scale can be achieved by using existing systems and facilities to market large volumes of financial products while avoiding investments in brick and mortar branches and supporting systems.

Industrial banks rarely deal with a customer face to face. Most operate out of offices located on upper floors of office buildings or in office parks. Transactions with customers are usually conducted over the internet, by telephone or mail, or through other entities that direct the business to the bank.

Most industrial banks are based in Utah because Utah's legal and regulatory environment is the most conducive to conducting interstate operations. Utah

also offers an excellent work force, transportation and telecommunication facilities, and below-average operating costs. Total industrial bank assets in Utah as of June 30, 2002 were \$92 billion. This is much larger than amounts for the industrial banks located in all other states combined. Because this development is largely confined to Utah, this article will focus on the banks in that state. A list of currently active industrial banks in Utah appears as an appendix.

## III. Advantages of an Industrial Bank

### A. Exemption from the Bank Holding Company Act

Prior to 1987, industrial banks were exempt from the BHCA on the same basis as non-bank banks. Specifically, industrial banks did not offer demand accounts, which was part of the definition of a bank in the BHCA. At the time, Utah law required an industrial loan corporation to legally reserve the right to delay payment of any request for a withdrawal from a deposit account for a minimum of seven days.

With the passage of the Competitive Equality Banking Act of 1987 (CEBA), industrial banks were given an express exemption from the BHCA in section 101(c)(2)(H),<sup>3</sup> which reads in pertinent part as follows:

#### (2) Exceptions

The term "bank" does not include any of the following:

...

#### (H) An industrial loan company, industrial bank, or other similar institution which is—

- (i) an institution organized under the laws of a State which, on March 5,

1987, had in effect or had under consideration in such State's legislature a statute which required or would require such institution to obtain insurance under the Federal Deposit Insurance Act [12 U.S.C.A. § 1811 *et seq.*].—

(I) which does not accept demand deposits that the depositor may withdraw by check or similar means for payment to third parties;

(II) which has total assets of less than \$100,000,000; or

(III) the control of which is not acquired by any company after August 10, 1987...

This exemption was not amended or otherwise affected by the passage of the Gramm-Leach-Bliley Act (GLB Act).

Industrial banks are now the only federally-insured depository institutions with the authority to offer a broad range of banking products and services in a holding company structure exempt from the BHCA. Industrial bank holding companies are not regulated by the FRB and can be affiliated with an organization engaged in any otherwise lawful activity. That includes securities and insurance companies and manufacturing and other commercial enterprises.

Another advantage is that an industrial bank holding company is not subject to the penalties imposed on a financial holding company if a subsidiary bank has an impairment of capital or receives a less than satisfactory CRA rating. A financial holding company must divest its bank subsidiaries if any one of

<sup>3</sup> 12 U.S.C. § 1841(c)(2)(H).

them has an impairment of capital lasting more than a specified period of time. In addition, a financial holding company and all of its subsidiaries are not permitted to offer new products or services or expand their operations in any way while a bank subsidiary has a less than satisfactory CRA rating. This latter penalty is especially important to holding companies with extensive non-banking operations, particularly when the bank is only a small portion of the group's total activities. An industrial bank would be subject to standard administrative actions to resolve an impairment of capital or a less than satisfactory CRA rating, but its holding company would not be threatened with forced divestiture except in extreme circumstances where the state regulator would take possession of the bank. CRA problems at an industrial bank would not result in any legal restrictions on operations of the holding company or affiliates.

#### **B. Authority to Offer a Broad Range of Deposits**

The limitation on demand deposits set forth in 12 U.S.C. section 1841(c)(2)(H) does not apply to any other kind of deposit account, including NOW accounts. This makes it possible for an industrial bank to offer a full range of deposit products and services to consumers, and a full range of products and services except checking accounts for commercial customers if the bank has grown to more than \$100 million in assets or was acquired by its current owner after March, 1987.

In addition to the marketing opportunities this presents, many industrial banks find it advantageous to fund operations with deposits. Deposits can be readily and cost effectively obtained in any amount through brokers and through direct marketing programs.

#### **C. Authority to Offer a Full Range of Banking Products**

An industrial bank can offer the same array of loan products and other banking services as any commercial bank. It can offer trust services, any kind of open or

closed-end loan, payment services, and any other product or service closely related to banking. Holding companies and affiliates can offer the same range of securities and insurance products and services as a financial holding company and engage in other lawful activities not permitted for a bank holding company (BHC) or a financial holding company.

#### **D. Authority to Serve Any Customer**

An industrial bank is not subject to any limitation on the kind of customers it can serve.

#### **E. Ability to Export Utah Laws Regarding Interest**

An industrial bank enjoys the same authority as other kinds of federally insured depository institutions to export the interest rate laws of its home state everywhere it does business. With minor exceptions, the Utah Consumer Credit Code (Title 70C of the Utah Code) does not impose caps on interest rates, finance charges, or other fees that a lender and borrower can specify in a credit contract. The lack of caps in Utah law is one of the reasons why the industrial bank industry has developed primarily in Utah.

#### **F. Eligibility Under Visa and MasterCard Rules to be an Original Issuer of Credit and Charge Cards**

Industrial banks have the same eligibility to be an original issuer of Visa or MasterCard credit, debit, charge and business cards as any commercial bank, savings bank, credit card bank, or credit union.

#### **G. Eligibility for Membership in a Federal Home Loan Bank**

FHLB funding is an excellent source of liquidity and correspondent services. Industrial banks have the same eligibility for membership as any other federally-insured depository institution.

#### **H. Regulation by the Utah Department of Financial Institutions**

The Utah Department of Financial Institutions and the Utah state government generally are very good to work with. Utah has traditionally been a national leader in deregulation and legislation to facilitate the development of financial industries. This has produced many benefits for both the state and the banks. Both the state and the regulators work hard to facilitate this development within the bounds of safety and soundness. The current Commissioner of Financial Institutions (Commissioner) is a veteran of more than 20 years and was recently reappointed to a third four-year term by the Governor of Utah. The Commissioner is a policy-making cabinet level position responsible for regulating all state-chartered depository institutions and administering the Utah Consumer Credit Code and all other credit-related statutes.

This favorable and supportive regulatory environment is another reason why industrial banks have mostly located in Utah.

#### **I. Utah as an Operations Site**

Utah offers many advantages as an operations site for technology-based financial institutions. While not the cheapest site for wages and commercial building costs, it is considerably less expensive than many other major urban areas in the nation. About 80 percent of the state's population lives within forty miles of Salt Lake City. This provides a well developed urban infrastructure to support business operations. The Salt Lake International Airport is a Delta hub and the nation's 11th busiest airport, assuring frequent convenient connections. It is located only 15 minutes from the downtown Salt Lake City financial district and no more than an hour by car from any suburb.

The state's workforce is one of its strongest assets. The biggest drawback is a very low unemployment rate. This problem is somewhat mitigated by the fact that the population of Utah is pro-

portionally the youngest in the nation and a large number of new graduates come into the labor market each year. Education and literacy levels are among the highest in the nation. Productivity levels in the Utah facilities of many national and international companies are among the highest in those organizations. Foreign language skills are especially strong because of the large number of Latter Day Saints (Mormon) church missionaries who have returned from two-year assignments to cities and countries in every continent on the planet.

#### IV. Disadvantages of an Industrial Bank

##### A. Prohibition on Commercial Checking Accounts

This limitation to NOW account checking authority limits the ability of an industrial bank to serve all the needs of commercial customers. On the other hand, it helps preserve good relations with commercial banks which do not tend to view industrial banks as significant threats because of the limits on branching and demand accounts.

##### B. Some Limitations on the Ability to Offer Certain Products and Services Permitted for a National Bank

Industrial banks have uncertain or inconsistent authority to offer some products and services permitted for a national bank, such as debt cancellation clauses in loan agreements.

#### Appendix

#### Utah Department of Financial Institutions Utah Industrial Loan Corporations as of June 30, 2002 (Figures in Millions)

Name	Total Assets
Advanta Bank .....	\$ 887
American Express Centurion Bank .....	14,699
American Investment Financial (Leucadia) .....	138
Associates Capital Bank .....	244
BMW Bank of North America .....	1,142
Celtic Bank .....	26
CIT Bank .....	31
Conseco Bank .....	2,799
EnerBank .....	14
Escrow Bank USA (GMAC Commercial Mortgage) .....	53
First Electronic Bank .....	2
G.E. Capital Financial .....	2,180
Merrick Bank .....	418
Merrill Lynch Bank USA .....	62,868
Morgan Stanley Bank .....	2,812
Pitney Bowes Bank .....	417
Provident Bank .....	1,924
Republic Bank .....	149
Transportation Alliance Bank (Flying J) .....	82
Universal Financial Corp. (Citigroup) .....	660
Volkswagen Bank USA .....	388
Volvo Commercial Credit .....	20
Webbank .....	18
Wright Express Financial .....	252
<b>TOTAL ASSETS (24 charters)</b>	<b>\$92,223</b>

**Applications Approved:** (through 6-30-02)  
Galileo Bank, Inc., Utah approval 10-15-01

**Applications Pending:** (through 10-1-02)  
Medallion Bank, accepted 6-21-02  
Goldman Sachs Bank USA, accepted 8-2-02  
Sears Bank, accepted 9-4-02  
UBS Bank USA, filed 12-02  
World Financial Capital Bank, filed 12-31-02

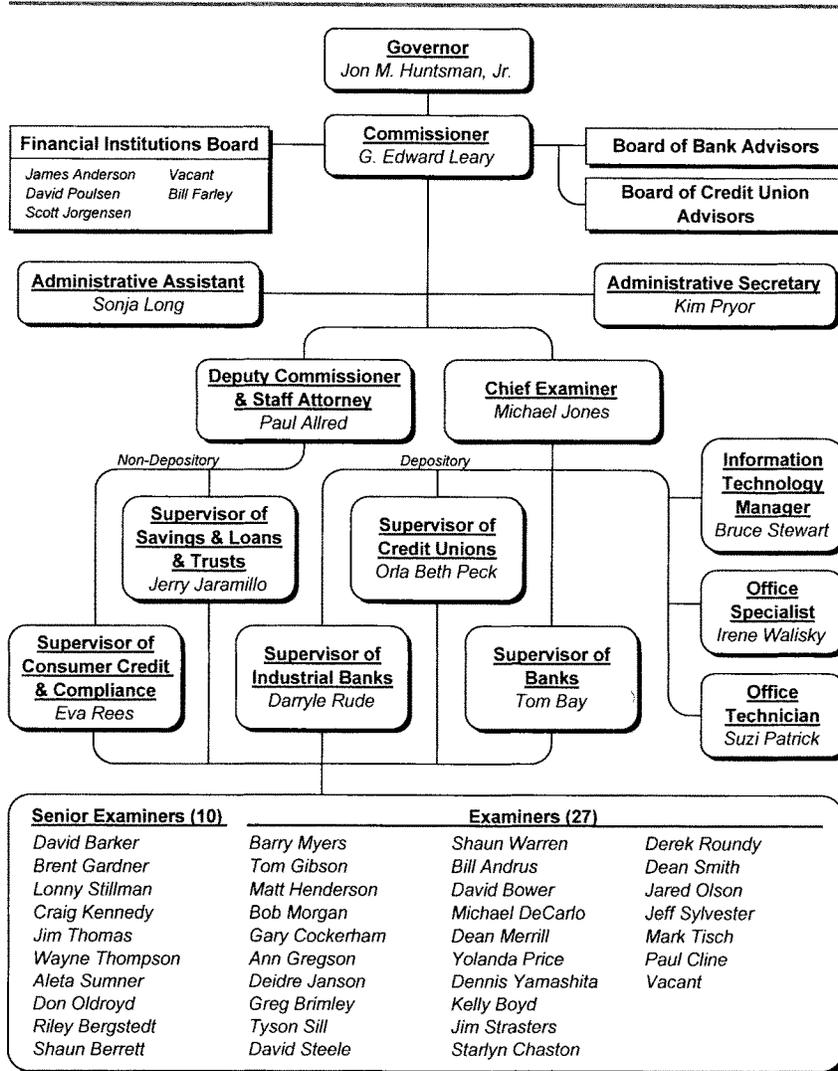
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# State of Utah

## Department of Financial Institutions

February 13, 2006





BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

January 20, 2006

ALAN GREENSPAN  
CHAIRMAN

The Honorable James A. Leach  
House of Representatives  
Washington, D.C. 20515

Dear Congressman:

I am writing in response to your request for the Board's views on several questions relating to industrial loan companies (ILCs). ILCs are state-chartered, FDIC-insured banks that may be acquired by unregulated entities under a special exemption in federal law. This special exemption allows any type of company, including a commercial firm or foreign bank, to acquire an ILC in a handful of states (principally Utah, California and Nevada) and avoid the consolidated supervisory requirements and activity restrictions that apply to the corporate owners of other types of insured banks under the federal Bank Holding Company Act.

When this exemption was adopted in 1987, ILCs were mostly small, locally owned institutions that had only limited deposit-taking and lending powers. However, much has changed since 1987 and recent events and trends highlight the potential for this exemption to undermine important general policies established by Congress that govern the banking system and to create an unlevel competitive playing field among banking organizations. The total assets held by ILCs have grown by more than 3,500 percent between 1987 and 2004, and the aggregate amount of estimated insured deposits held by ILCs has increased by more than 500 percent just since 1999. Certain legislative proposals pending in Congress also would enhance the significance of the ILC exemption by giving ILCs the ability to open *de novo* branches across the nation and offer interest-bearing checking accounts to business customers.

Importantly, while only a handful of states may continue to charter exempt ILCs, there is no limit on the number of new exempt ILCs that these states may charter in the future. In fact, because Congress has closed the so-called "nonbank bank" and unitary thrift loopholes, the ILC exemption is now the primary means by which commercial firms may control an FDIC-insured bank engaged in broad lending and deposit-taking activities and thereby breach the general separation of banking and commerce.

Your letter highlights the important public policies implicated by this exemption. Consolidated supervision of the parent company of an insured bank provides important protections to the subsidiary bank and the federal safety net that supports the bank. It complements, and is in addition to, supervision of the subsidiary bank by the bank's primary supervisor(s). For these reasons, Congress has required that the corporate

The Honorable James A. Leach  
Page Two

owners of full-service insured banks, and foreign banks seeking to acquire a bank in the United States, be subject to consolidated supervision. In 1999, Congress also reaffirmed the longstanding separation of banking and commerce. In addition, in the Gramm-Leach-Bliley Act, Congress specifically conditioned the ability of full-scope securities and insurance firms to acquire or control insured bank(s) on the requirement that the parent holding company ensure its subsidiary bank(s) remain well capitalized and well managed and maintain a "satisfactory" or better rating under the Community Reinvestment Act. The ILC exemption permits the corporate owners of ILCs to operate outside this prudential framework.

The Government Accountability Office (GAO) recently reviewed the growth of ILCs and the implications of continuing to allow these institutions to operate outside the prudential framework established for the corporate owners of other insured banks. The GAO report recommends that Congress consider eliminating or modifying the exemption that currently allows companies to own an FDIC-insured ILC without complying with the supervisory requirements and activity restrictions that apply to the corporate owners of other insured banks.

The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption. These changes are undermining the prudential framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision. These are crucial decisions that should be made in the public interest after full deliberation by the Congress; they should not be made through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of states.

For these reasons, I urge Congress to review the ILC exemption and the potential that it will further undermine the policies Congress has established to govern the banking system generally and create an unlevel competitive playing field among organizations that own a bank.

Responses to the specific questions posed in your letter are enclosed. I hope this information is helpful.

Sincerely,  


Enclosure

**1. Why were ILCs given their special status in federal banking law in 1987, and what has changed since the ILC loophole was created in 1987?**

The federal Bank Holding Company Act (BHC Act), originally enacted in 1956, establishes a comprehensive prudential framework for the regulation and supervision of companies that own a bank (referred to as “bank holding companies”). This framework, which includes supervisory requirements and restrictions on the permissible activities of bank holding companies, is designed to help protect a bank from the risks posed by the activities or condition of its parent company (and the parent’s nonbank subsidiaries) and maintain the general separation of banking and commerce in the American economy.

In the early 1980s, some commercial and other firms sought to evade the restrictions in the BHC Act by establishing FDIC-insured banks that performed some, but not all, of the functions necessary to be considered a “bank” for purposes of the BHC Act.<sup>1</sup> In 1987, Congress enacted the Competitive Equality Banking Act (CEBA) to close this so-called “nonbank bank” loophole and prevent further evasions of the BHC Act. In particular, CEBA expanded the definition of “bank” in the BHC Act to include: (1) any FDIC-insured bank (regardless of the activities it conducts); and (2) any banking institution that both offers transaction accounts and makes commercial loans (regardless of whether it is FDIC-insured).

At the time, Congress also adopted certain exceptions to this new and broad definition of “bank” for specific types of institutions, such as limited-purpose credit card banks and trust companies. However, restrictions were placed on these limited-purpose institutions to ensure that they could not operate as full-service banks. For example, exempt credit card banks were permitted to engage only in credit card operations and were prohibited from processing payments for affiliates or others.<sup>2</sup> Similarly, exempt trust companies were permitted to engage only in trust or fiduciary functions and were prohibited from obtaining payment or payment-related services from the Federal Reserve for themselves or other affiliated or unaffiliated entities.

A separate exception adopted in 1987 allows a company to acquire an industrial loan company (ILC) if the ILC is chartered in certain states (primarily Utah, California and Nevada). Although certain conditions were placed on an ILC operating under this exception, these limitations are less comprehensive and binding than the restrictions placed on exempt credit card banks or trust companies. For example, to retain its exemption, an ILC has the option of either keeping its total assets below \$100 million or not accepting demand deposits that the depositor may withdraw by check or similar means for payment

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<sup>1</sup> At this time, an institution was considered a “bank” for BHC Act purposes only if the institution both accepted demand deposits and was engaged in the business of making commercial loans.

<sup>2</sup> See S. Rept. 100-19, 100<sup>th</sup> Cong., 1<sup>st</sup> Sess. at 30 (1987).

to third parties.<sup>3</sup> These limited restrictions, for example, permit an ILC--even one with more than \$100 million in assets--to engage in the full range of commercial, mortgage, credit card and consumer lending activities; offer payment-related services, including Fedwire, automated clearing house (ACH) and check clearing services, to affiliated and unaffiliated persons; and accept time and savings deposits, including certificates of deposit (CDs), from any type of customer.

The legislative history to CEBA offers little explanation as to why the ILC exemption was adopted. This may be because in 1987 ILCs generally were small, locally owned institutions that had only limited deposit-taking and lending powers under state law. At that time, for example, the majority of ILCs had less than \$50 million in assets and the largest ILC had assets of less than \$400 million. Moreover, in 1987, the relevant states were not actively chartering new ILCs. Utah, for example, had a moratorium on the chartering of new ILCs at the time CEBA was enacted.

The landscape related to ILCs has changed significantly since 1987, a fact recently documented by the Government Accountability Office (GAO).<sup>4</sup> In 1997, for example, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves "banks," and permitted ILCs to exercise virtually all of the powers of state-chartered commercial banks. In addition, Utah and certain other grandfathered states have since begun actively to charter new ILCs and promote ILCs as a method for companies to acquire a bank while avoiding the requirements of the BHC Act.

As a result, recently there has been a significant change in the number, size and nature of ILCs operating under the exemption. For example, since 1997 the number of Utah-chartered ILCs has more than doubled, and the aggregate amount of assets controlled by Utah-chartered ILCs now is more than *sixteen* times the aggregate total assets of all the banks, savings associations and credit unions chartered in that state.<sup>5</sup> In fact, one ILC operating under the exception now has more than \$58 *billion* in assets and more than \$50 *billion* in deposits. An additional seven exempt ILCs each have more than \$1 billion in deposits. The aggregate amount of estimated insured deposits held by all ILCs has grown by more than 500 percent since 1999, and the total assets of all ILCs have grown by more than 3,500 percent from 1987 to 2004 (from \$3.8 billion to \$140 billion).

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<sup>3</sup> An ILC that was in existence in a grandfathered state on August 10, 1987, also may retain its exemption if it has not experienced a change in control since that date.

<sup>4</sup> See *Industrial Loan Companies: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 (Sept. 2005).

<sup>5</sup> All asset and deposit data are as of September 30, 2005, unless otherwise noted. Asset totals do not include credit card or other assets that have been securitized by an ILC or other institution and, thus, may understate the activities of an ILC or other institution.

Several large, internationally active commercial companies, including General Motors, General Electric, Pitney Bowes, BMW, Volkswagen and Volvo, also now own ILCs under this exception and use these banks to support various aspects of their global commercial operations. Wal-Mart, the nation's largest retailer, also has filed applications with the Utah Department of Financial Institutions and the Federal Deposit Insurance Corporation to acquire an FDIC-insured ILC.

In addition, while only a handful of states have the ability to charter exempt ILCs, there is no limit on the number of exempt ILCs these grandfathered states may charter in the future. Thus, there is no limit to the number of exempt ILCs that may be acquired or established in the future by companies that operate outside the prudential framework and activities limitations that Congress has established in the BHC Act.

**2. Does the ILC loophole undermine the general policies that Congress has established for the financial system, including the policies of (i) maintaining the general separation of banking and commerce, (ii) requiring consolidated supervision of companies that own insured banks and foreign banks that seek to engage in the banking business in the United States, and (iii) allowing an organization to own a bank and engage in broad securities, insurance and other financial activities only if the organization complies with the capital, managerial and other criteria set forth in the GLB Act?**

Yes. The United States has a tradition of maintaining the separation of banking and commerce. In the Gramm-Leach-Bliley Act (GLB Act) of 1999, Congress reaffirmed this policy by closing the unitary thrift loophole, which previously allowed commercial firms to control an FDIC-insured savings association, and by authorizing financial holding companies as a general matter to affiliate only with companies that are engaged in activities determined (by Congress or the Board, in consultation with the Treasury Department) to be financial in nature or incidental to financial activities.<sup>6</sup>

In the GLB Act, Congress also determined to allow a bank holding company to become a financial holding company, and thereby engage in a wide array of financial activities (including full-scope securities underwriting, insurance underwriting and merchant banking), only if all of the company's depository institution subsidiaries are and

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<sup>6</sup> Financial holding companies may, to a limited extent, engage in or affiliate with a company engaged in a nonfinancial activity if the Board determines that the activity is "complementary" to the company's financial activities and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. See 12 U.S.C. § 1843(k)(1)(B). Significantly, this limited exception was enacted in place, and after rejection, of provisions that would have authorized broader mixings of banking and commerce. See, e.g., H. Rept. 106-74, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess., Part 1 at 10-11 (1999); H. Rept. 105-164, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess., Part 1 at 13-14 (1997).

remain well capitalized and well managed. In addition, the Act prohibits a bank holding company from becoming a financial holding company, and a financial holding company from commencing any newly authorized financial activity, if any of the company's insured depository institution subsidiaries has less than a "satisfactory" record of performance under the Community Reinvestment Act (CRA). These supervisory requirements imposed on financial holding companies as a condition to their exercise of the newly authorized financial powers are stricter than those that ordinarily apply to insured banks.<sup>7</sup>

Since 1956, Congress also has required the corporate owners of full-service banks to be supervised on a consolidated basis. As discussed further below, consolidated supervision of the organizations that control banks not only helps prevent bank failures, it also provides important tools for managing and resolving bank failures if and when they do occur. In fact, following the collapse of Bank of Commerce and Credit International (BCCI), which lacked a single supervisor capable of monitoring its diverse and global activities, Congress amended the BHC Act in 1991 to require that foreign banks demonstrate that they are subject to comprehensive supervision on a consolidated basis prior to acquiring a bank in the United States.

Because ILCs are exempt from the definition of "bank" in the BHC Act, their corporate owners are not subject to these supervisory requirements and activity restrictions that Congress has established to govern the banking system generally. Accordingly, continued expansion or exploitation of the ILC exemption undermines the general policies that Congress has established concerning the mixing of banking and commerce, consolidated supervision of banking organizations operating in the United States, and the supervisory criteria applicable to diversified financial firms that seek to affiliate with an insured bank. The Board has on several occasions stated its belief that it is important for the Congress to decide, after a full and careful evaluation, the nation's policies in these areas, rather than allowing these policies to be decided for the Congress on a de facto basis through the exploitation or expansion of an exemption available only to one type of institution chartered in certain states.

### 3. Does the ILC loophole raise important questions of competitive equity?

Yes. As discussed above, companies that own an exempt ILC are not subject to the activity restrictions and supervisory requirements that apply to the corporate owners of other types of full-service insured banks under the BHC Act. This provides the corporate

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<sup>7</sup> The prompt corrective action provisions of the Federal Deposit Insurance Act, for example, generally are triggered only when an insured bank ceases to be at least "adequately capitalized." See 12 U.S.C. § 1831o. In addition, the CRA performance of an insured depository institution normally is not a factor that must be considered in determining whether the parent company of the institution may engage in, or acquire a company engaged in, nonbanking activities. See *id.* at §§ 2901 *et seq.*

owners of exempt ILCs a significant competitive advantage over the owners of other types of banking institutions and creates an unlevel competitive playing field among banking organizations. For example, the exemption permits:

- \* A manufacturing company, retail firm, or real estate brokerage firm to acquire an FDIC-insured bank *without* regard to the BHC Act's activity restrictions that are designed to maintain the general separation of banking and commerce;
- \* A securities or insurance firm to acquire an FDIC-insured bank *without* being obligated to keep the bank well capitalized and well managed or maintain the bank's CRA rating at "satisfactory" or better;
- \* A diversified financial or commercial firm to acquire an FDIC-insured bank and integrate the bank into its overall operations *without* being subject to the consolidated supervisory requirements that Congress has established to protect insured banks that operate within nonexempt corporate organizations; and
- \* A foreign bank to acquire an FDIC-insured bank that accepts retail deposits in the United States *even if* the foreign bank is *not* subject to comprehensive supervision on a consolidated basis by its home country supervisor.

The application of important public policies--such as those governing the proper mixing of banking and commerce and the role of consolidated supervision of banking organizations--should not depend on the location of a banking institution's charter or the particular nomenclature used to identify the institution. Rather, these policies should be decided by Congress after a full and careful evaluation and then applied to all organizations that own a bank in a competitively equitable manner.

**4. What is consolidated supervision? How does it differ from supervision of a bank? Does consolidated supervision of a parent company add value in protecting the deposit insurance funds and the federal taxpayer from problems that may occur in an organization that owns a bank?**

Consolidated supervision is a supervisory framework that provides a supervisor the tools it needs--such as reporting, examination, capital and enforcement authority--to understand, monitor and, when appropriate, restrain the risks associated with an organization's consolidated or group-wide activities. Consolidated supervision is a fundamental component of banking supervision in the United States and, increasingly, abroad. This is so because it provides important protection to the insured banks within the overall organization and the federal safety net that supports those banks. In addition, consolidated supervision aids in the detection and prevention of financial crises and, thus, mitigates the potential for systemic risk in the financial system.

Large organizations increasingly operate and manage their businesses on an integrated basis with little regard for the corporate boundaries that typically define the jurisdictions of supervisors. Risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions within the overall organization. In order to fully understand and assess these risks, a supervisor must be able to analyze a business line on a consolidated basis across the organization, and then determine how the risks are transferred to and managed by the organization and its individual legal components.

This process is particularly crucial to understanding the risks to banks that are part of a larger organization. For example, an ILC or other bank owned by a large firm may be partially or entirely dependent upon affiliates for critical services, such as computer support, treasury operations, accounting, personnel, management and even premises. Moreover, banks that are part of a large organization sometimes have no business independent of the bank's affiliates. For example, the bank's loans and deposits may be derived or solicited largely through or from affiliates. In addition, activities conducted by the parent or its nonbank subsidiaries or a high degree of leverage at the parent company level may weaken the parent company's ability to assist its subsidiary bank in times of trouble. In these situations, it is particularly important that an agency have authority to examine the entire organization, address its capital strength, and enforce safe and sound policies and operations throughout the organization and across affiliates. Otherwise, problems at the parent company or its nonbank affiliates may spread to the insured bank or hamper the ability of the parent organization to serve as a source of strength for the bank.

The consolidated supervisory authority granted the Board in the BHC Act and other federal banking law provides the Board with both the ability to understand the financial strength and risks of the overall banking organization and the authority to address significant management, operational, capital and other deficiencies within the overall organization *before* these deficiencies pose a danger to a subsidiary insured bank and the federal safety net. The hallmarks of this supervisory framework are broad grants of authority to the Board to examine and obtain reports from bank holding companies and each of their subsidiaries, establish consolidated capital requirements for bank holding companies and take supervisory actions with respect to bank holding companies and their nonbank subsidiaries for unsafe or unsound practices or violations of law. Consolidated capital requirements are an important tool for helping to ensure that a parent organization is able to serve as a source of financial strength, not weakness, to its subsidiary insured depository institutions.

The Board's consolidated supervisory authority over bank holding companies complements, and is in addition to, the authority that the primary federal or state supervisors may have over the company's subsidiary depository institutions. Importantly, the Board's supervisory authority over bank holding companies and their nonbank subsidiaries exceeds in several key respects the supervisory authority that a federal banking

agency, acting in its capacity as a bank supervisor, may have with respect to the corporate parent or nonbank affiliates of an insured bank (such as an ILC).

For example, the BHC Act grants the Board broad authority to examine a bank holding company and its nonbank subsidiaries, whether or not the company or affiliate engages in transactions or has relationships with a depository institution subsidiary.<sup>8</sup> Pursuant to this authority, the Federal Reserve conducts examinations of all large, complex bank holding companies on a routine basis, which allows the Board to review the organization's systems for identifying and managing risk across the organization and its various legal entities and the overall financial strength of the organization.

In contrast, the appropriate federal banking agency for an insured bank, such as an ILC, is authorized to examine affiliates of the bank (other than subsidiaries of the bank) *only* to the extent necessary to disclose the relationship between the bank and the affiliate and the effect of the relationship on the bank. This examination authority, while important and valuable in supervising the insured bank, is significantly more limited than the authority granted the Board under the BHC Act.

In addition, the Board has broad authority to take enforcement action, including issuing cease and desist orders and imposing civil money penalties, against any bank holding company and any nonbank subsidiary of a bank holding company. This authority includes the ability to stop or prevent a bank holding company or nonbank subsidiary from engaging in an unsafe or unsound practice in connection with its own business operations. On the other hand, the appropriate federal banking agency for an insured bank has only limited authority to take enforcement actions against the corporate owner of an exempt bank and its nonbank subsidiaries; this authority can only be used if the owner or its nonbank subsidiaries engage in an unsafe or unsound practice *in conducting the business of the bank*. Thus, unsafe and unsound practices that weaken the corporate owner of an exempt bank, for example by significantly reducing the capital of the parent company, are generally beyond the scope of the enforcement authority of the appropriate federal banking agency for an insured bank.

The GAO recently reviewed the differences in the Board's authority over bank holding companies and the authority of the FDIC, as the primary federal supervisor of ILCs, over the holding companies of ILCs. As the GAO concluded, "[a]lthough the FDIC has supervisory authority over an insured ILC, it does not have the same authority to supervise ILC holding companies and affiliates as a consolidated supervisor." Moreover,

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<sup>8</sup> In the case of certain functionally regulated subsidiaries of bank holding companies, the BHC Act directs the Board to rely to the fullest extent possible on examinations of the subsidiary conducted by the functional regulator for the subsidiary, and requires the Board to make certain findings before conducting an independent examination of the functionally regulated subsidiary. 12 U.S.C. § 1844(c)(2)(B).

the GAO concluded that, as a result of these differences, "ILCs in a holding company structure may pose more risk of loss to the [Bank Insurance] Fund than other types of insured depository institutions in a holding company structure."<sup>9</sup>

**5. Is it appropriate--as bills currently pending in Congress would do--to allow the corporate parents of ILCs to continue to operate outside the requirements and limitations of the BHC Act while at the same time granting ILCs the opportunity to offer NOW accounts to business customers or branch de novo nationwide?**

No. Currently, there are two bills pending in Congress that would significantly expand the powers of exempt ILCs. The first, H.R. 3505 (the Financial Services Regulatory Relief Act of 2005), would allow exempt ILCs to open *de novo* branches throughout the United States. The second, H.R. 1224 (the Business Checking Freedom Act of 2005), would affirmatively authorize exempt ILCs to offer interest-bearing, checkable transaction accounts to business customers.<sup>10</sup>

The Board has opposed these expansions of ILC authority because they are inconsistent with the limited and historical functions of ILCs and the terms of their special exemption in current law. In addition, because these proposals would substantially increase the powers of exempt ILCs and the attractiveness of the ILC exemption, they would exacerbate the competitive advantage that the corporate owners of ILCs have over other banking organizations and further undermine the framework that Congress has established for the corporate owners of full-service banks.

For example, together these bills would allow domestic firms or foreign banks that are not subject to consolidated supervision--including consolidated capital, examination and reporting requirements--to own an FDIC-insured bank that has branches throughout the United States and has the ability to offer checkable transaction accounts to the full range of corporate and individual customers. Thus, these proposals would allow institutions that operate outside the prudential supervisory framework established by Congress to become, and operate as, the functional equivalent of full-service commercial banks. They also would allow a commercial or retail firm that owns an ILC to establish a branch of the ILC at any location across the United States despite the limitations established by Congress to maintain the general separation of banking and commerce.

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<sup>9</sup> See *Industrial Loan Companies: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*, GAO-05-621 at p. 79 and 80 (Sept. 2005).

<sup>10</sup> H.R. 3505 was approved by the House Financial Services Committee in November 2005, but has not yet been taken to the House floor. H.R. 1224 was approved by the full House in July 2005. Importantly, the companion Senate bill (S. 1586) to H.R. 1224 would not authorize exempt ILCs to offer checkable accounts to business customers.

The limits contained in H.R. 3505 and H.R. 1224 do not adequately address these issue or the other important issues raised by the ILC exemption. For example, under H.R. 3505, even those ILCs established or acquired *after* October 1, 2003, could open interstate de novo branches unless an appropriate state supervisor for the ILC affirmatively determined that a company controlling the ILC derived more than 15 percent of its annual gross revenues from activities that are not “financial in nature or incidental to a financial activity.” Similarly, H.R. 1224 would allow an ILC established or acquired *after* October 1, 2003, to offer checkable accounts to business customers if the ILC’s chartering state determined that the companies controlling the ILC met this financial test. However, the bills do not tie this test to a federal definition of “financial activity” and, thus, allow states to be both expansive and inconsistent in their definition of what constitutes a “financial” activity.

The bills also would allow *any* ILC that received FDIC insurance before October 1, 2003, or had an application for deposit insurance pending on that date, to open de novo branches and offer checkable accounts to business customers nationwide so long as the institution does not experience a change in control. Thus, the bills would allow those commercial and retail firms that acquired an ILC before October 1, 2003, to transform the institution into a full-service retail bank and open branches of the bank across the nation.

The limits contained in H.R. 3505 and H.R. 1224 also do not address the other risks and issues presented by ILCs. For example, the bills fail to address the important issues associated with allowing domestic firms or foreign banks that are not subject to consolidated supervision to operate a full-service insured bank on a nationwide basis without federal supervision of the parent company or foreign bank. The bills also fail to address the competitive equity issues raised by enhancing an exemption that is available to only one type of financial institution that can only be chartered in a handful of states.

As the Board has testified, the Board does not oppose granting ILCs the ability to open de novo branches or offer checkable business accounts if the corporate owners of ILCs that exercise these expanded powers are covered by the same supervisory and regulatory framework that applies to the owners of other full-service insured banks. Stated simply, if ILCs want to benefit from expanded powers granted other insured banks, then they and their corporate parents should be subject to the same rules that apply to the owners of other full-service insured banks.

**6. The bill that I have introduced would require the companies that own an ILC to comply with the same supervisory requirements and activity restrictions that apply to financial holding companies. Would enactment of this bill address the Board’s concerns regarding ILCs?**

The bill you have introduced, H.R. 3882, would subject the corporate owners of ILCs to the same prudential framework—including consolidated supervisory requirements,

bank-level capital, managerial and CRA criteria, enforcement mechanisms, and activity limitations--that apply to financial holding companies under the BHC Act and other federal banking laws. This approach would address the Board's concerns and ensure a fair and level competitive playing field for all banking organizations.



**NATIONAL ASSOCIATION OF REALTORS®**

*The Voice For Real Estate®*

500 New Jersey Avenue, N.W.  
Washington, DC 20001-2020  
202.383.1194 Fax 202.383.7580  
[www.realtors.org/governmentaffairs](http://www.realtors.org/governmentaffairs)

Thomas M. Stevens, CRB, CRS, GRI  
President

Dale A. Stinton, CAE, CPA, CMA, RCE  
EVP/CEO

GOVERNMENT AFFAIRS  
Jerry Giovannello, Senior Vice President  
Walter J. Witek, Jr., Vice President

**HEARING BEFORE THE HOUSE FINANCIAL SERVICES  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND  
CONSUMER CREDIT**

**ENTITLED**

**“ILCS—A REVIEW OF CHARTER, OWNERSHIP, AND  
SUPERVISION ISSUES”**

**STATEMENT OF THE**

**NATIONAL ASSOCIATION OF REALTORS®,  
JULY 12, 2006**

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REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.



On behalf of more than 1.3 million members of the National Association of REALTORS® (NAR), I am pleased to submit our views to the House Financial Services Subcommittee on Financial Institutions and Consumer Credit for the hearing entitled, “ILCs—A Review of Charter, Ownership, and Supervision Issues.”

The National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, including NAR’s five commercial real estate affiliates. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®.

#### **NAR Opposes Commercial Firms Owning Banks**

NAR is extremely concerned about both Wal-Mart and Home Depot’s intention to acquire industrial loan companies (ILC) chartered by the state of Utah. NAR is on record as opposing Wal-Mart’s application for federal deposit insurance for Wal-Mart Bank and opposing Home Depot’s Notice of Change in Control related to its proposed acquisition of EnerBank USA.<sup>1</sup> Our specific concerns regarding both the Wal-Mart and Home Depot applications are detailed further in this statement.

NAR believes that banks must be “honest brokers” of financial services and not be swayed into making credit and other business decisions based on their affiliation with commercial firms. When commercial firms are allowed to engage in banking, the bank functions under an inherent and irreconcilable conflict of interest. The bank’s commercial parent will be tempted to use the bank in a manner that furthers its own corporate objectives, which may be at odds with what is in the best interests of the bank subsidiary, customers, competitors, and our financial system.

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<sup>1</sup> Federal Deposit Insurance Corporation (FDIC) Public Hearings Regarding the Deposit Insurance Application of Wal-Mart Bank, testimony of Testimony of Thomas M. Stevens, CRB, CRS, GRI, President, National Association of REALTORS® (April 11, 2006) and Letter to John F. Carter, Regional Director, Federal Deposit Insurance Corporation Regional Office on the Home Depot Notice of Change in Control related to its proposed acquisition of EnerBank USA (June 5, 2006).

REALTORS® are also concerned about the competitive impact of giving large commercial firms benefits that come with owning a federally insured bank. For example, if an ILC owned by a commercial firm provided loans on favorable terms to suppliers or customers of its parent, it would put other commercial firms at a disadvantage. Permitting commercial firms to acquire banks also provides them with access to the nation's payments system, which increases risk incurred by other participants. We believe that mixing banking and commerce creates risks to the financial system because a bank owned by a commercial firm may not have the freedom to exercise the discipline needed to make independent credit judgments. For these reasons, NAR is encouraged that Congress is taking steps to address the issue of commercial firms owning ILCs and asks that the House Financial Services Committee consider legislative options to tighten or eliminate the ILC loophole that permits commercial firms to own this type of federally insured state bank. Finally, considering the FDIC has a number of applications relating to ILCs that can be granted at any time, NAR urges Congress to send a clear signal to the Board of Directors of the FDIC to impose a moratorium on the approval of any commercial companies' applications for federal deposit insurance for ILCs.

#### **Wal-Mart Bank**

Wal-Mart's pending federal deposit insurance application marks the latest chapter in Wal-Mart's continuing effort to gain a foothold entry into the banking industry. If permitted to establish an affiliation, it is inevitable that Wal-Mart will attempt to expand this foothold. We believe that Wal-Mart's effort to obtain a federally-insured depository institution, if successful, will establish a dangerous precedent that will inevitably lead to an erosion of the national policy against mixing of banking and commerce and have serious consequences for the continued stability and growth of the nation's financial system. NAR has urged the FDIC to carefully consider the risks of permitting Wal-Mart to control an insured bank, even one whose powers are, at least initially, purported to be limited.

#### *Conflict of Interest*

Wal-Mart has publicly stated that the company's sole motivation is to have the Bank act as a vehicle for providing Wal-Mart with direct access to the payment system to process electronic

payments such as debit and credit card and Automated Clearing House (ACH) transactions. However, the publicly available portions of Wal-Mart's FDIC application expressly provide that "the Bank will also offer certificates of deposit." The statement is unqualified. As best as we can determine, Wal-Mart proposes no limitation in the application that precludes Wal-Mart from significantly expanding the bank's deposit taking activities at any time. Some of the significant risks raised in this statement will undoubtedly come to fruition if a Wal-Mart Bank is able to compete with other depository institutions in accepting deposits. Wal-Mart would divert the funds raised to investments in securities rather than to loans to residents and businesses in the communities in which it raised the funds. In effect, Wal-Mart Bank will deprive local banks and thrifts from funds that would be lent locally. These risks would be exacerbated if the Bank were to engage at some future time in lending activities. Moreover, we do not believe that requiring the bank to obtain the FDIC's approval before expanding its activities or inviting public comment if the bank seeks to expand its activities will adequately protect the public interest. Once the door is opened, it is exceedingly difficult to close it.

As we have stated, NAR believes that banks must be "honest brokers" of financial services and not be swayed into making credit and other business decisions based on their affiliation with commercial firms. This is one of the key reasons banks are not permitted to engage in commercial activities. And when commercial firms are allowed to engage in banking, the bank also functions under an inherent and irreconcilable conflict of interest. While there are existing restrictions on transactions between a bank and its affiliates, as evidenced by the Home Depot proposal, we think that the bank's commercial parent will inevitably use the bank to further the corporate objectives of the company, which may be at odds with what is in the best interests of the bank subsidiary, customers, competitors, and our financial system. If the parent is in the midst of a financial crisis, ethical and legal behavior by senior management cannot always be assumed. No company is immune from improper actions of its employees. Indeed, even Wal-Mart has been victimized by fraudulent actions of its dishonest Vice Chairman.<sup>2</sup> We cannot afford to open the door to actions that threaten the safety and soundness of the banking system.

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<sup>2</sup> See [http://walmart.nwanews.com/wm\\_story.php?paper=adg&storvid=144830](http://walmart.nwanews.com/wm_story.php?paper=adg&storvid=144830).

If the Wal-Mart Bank were to expand its business plan into retail banking, it is reasonable to expect that it would use the enormous financial resources of its parent, Wal-Mart Stores, to seek to become the dominant, or even sole, player in banking in its rural markets. That is precisely what has already happened in many small retail markets around the country. If Wal-Mart Bank becomes the main or only provider of financial services in a market, it would place commercial competitors at a serious disadvantage in seeking financial services. The bank would have a strong incentive to base its credit decisions on whether the applicant competes with the bank's parent. Furthermore, Wal-Mart Bank could position itself to provide loans on favorable terms to the suppliers of Wal-Mart Stores, which would put commercial firms that are not affiliated with a bank at a competitive disadvantage. These factors are uniquely significant in the case of Wal-Mart considering that the opening of a Wal-Mart store has been the death knell of the small businesses in many small towns.

*Risk to the Stability of the Financial System*

Federal Reserve Board Chairman Ben Bernanke has recently reaffirmed statements made by former Federal Reserve Chairman Alan Greenspan and other Federal Reserve Board Governors raising concerns about the industrial loan company loophole. This loophole is the last significant exception that permits a commercial firm to control a federally insured bank that is broadly engaged in lending and deposit taking activities. In a written statement provided in response to a question asked by Representative Brad Sherman at the February 15<sup>th</sup> House Financial Services Committee hearing, Chairman Bernanke explained that Congress should decide the extent to which mixing of banking and commerce should be permitted, if at all. He noted that—

[T]he Board has encouraged Congress to review the exemption in current law that allows a commercial firm to acquire an FDIC-insured industrial bank (ILC) chartered in certain states without regard to the limits Congress has established to maintain the separation of banking and commerce. Continued exploitation of the ILC exception threatens to remove this important policy decision from the hands of Congress.

We believe Chairman Bernanke's statement supports NAR's recommendation that the FDIC should not approve the Wal-Mart application until Congress has an opportunity to consider the appropriateness of existing law and vote on whether to sunset existing authority, as it did in 1999 when the Gramm-Leach-Bliley Act slammed the door on commercial firms acquiring thrifts.

A recent report of the U.S. Government Accountability Office questions the risk to the Bank Insurance Fund presented by nonfinancial companies of insured industrial loan companies.<sup>3</sup> The GAO concluded that although the FDIC has supervisory authority over an insured ILC, it has less extensive authority to supervise ILC holding companies than the consolidated supervisors of bank and thrift holding companies. Therefore, according to the GAO, from a regulatory standpoint, ILCs controlled by commercial companies and supervised by the FDIC may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company. Restructuring the supervisory framework for ILCs along the lines of the Federal Reserve Board's comprehensive umbrella supervisory authority over bank holding companies is not the solution because it will simply leave the door open to a continued mixing of banking and commerce. Because of the overriding policy reasons not to permit mixing banking and commerce, the solution is to close the ILC loophole once and for all.

One of the most important risks raised by the application is that providing Wal-Mart with direct access to the payments system would enable Wal-Mart to spread the risk of the company's commercial operations to other participants in the payment system. Today, banks serve as trusted intermediaries when making or collecting payments on behalf of customers. Banks typically will require corporate customers to meet certain credit standards before the bank will agree to act as the customers' "window" to the payment system. In effect, the bank guarantees to other banks participating in the payments system that it will make good on obligations arising from payments the bank makes on behalf of its customers. For example, if a bank originates an ACH debit on behalf of a merchant, the bank guarantees the receiving bank that it will reimburse the receiving bank if the ACH debit was not authorized by the receiving bank's customer. This "guarantee" is backed up by a thorough, independent credit review of the merchant's credit.

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<sup>3</sup> "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621 (September 2005).

The process breaks down, however, when the merchant's bank is a captive of the merchant, for the bank cannot exercise independent credit judgment. It must do what its parent, in this case, Wal-Mart, tells it to do. There is nothing that can prevent Wal-Mart from compelling its bank to initiate wire transfers or ACH debits and credits and transferring risk of loss to the banking system. Given its relatively limited resources (capital of merely \$150 million after three years), and the billions of dollars of payments Wal-Mart expects to process through the bank, Wal-Mart Bank's failure to exercise independent credit judgment will mean that Wal-Mart's credit risk will be transferred to the payment system from the banks with which it now does business and that apply controls on the amount of payments they process for Wal-Mart. As a result, banks participating in the payment system will be forced to absorb the risk of a default by Wal-Mart Stores. Such an involuntary transfer of credit risk is unacceptable and is another negative aspect of the Wal-Mart application.

If the Wal-Mart Stores parent of a Wal-Mart Bank were ever to find itself under financial pressure, it would be tempting for it to abuse its bank in a manner that enables it to resolve the problem. As we know from the collapse of Enron, WorldCom, and others in the last few years, circumstances sometimes spin out of the control of management and not all of those involved act within the law. If Enron or WorldCom had owned and abused its relationship with a federally insured depository institution, the impact on our economy would have been far worse. It is not reasonable to assume that if Wal-Mart found itself in a crisis, it would be entirely forthcoming about what is happening in communicating with its shareholders, the SEC, the FDIC or Federal Reserve Board, the Utah bank supervisor, or any other regulator. By the time these parties learned of the true condition of the enterprise, it could very well be too late to save the Bank or minimize harm to the rest of the financial system.

Accordingly, the National Association of REALTORS® opposes the Wal-Mart Bank deposit insurance application because it does not meet the statutory standards for approval and because the issue is of such significance that we believe Congress should decide as to whether it is appropriate to permit the mixing of banking and commerce such these circumstances.

**Home Depot Bank**

Home Depot's proposed business plan is a perfect example of why banking and commerce should not be mixed. Home Depot's plan calls for channeling credit primarily to home improvement contractors that are their customers. This plan will have an anti-competitive effect and adversely affect Home Depot's competitors and other banks.

*Risk to the Stability of the Financial System and Conflict of Interest*

As we have already stated, NAR believes that when banking and commerce mix, the inevitable results are conflicts of interest, harm to the competitive landscape, and risks to the financial system. Will a bank that is owned by a commercial company treat its customers that are suppliers and customers of its [commercial] parent the same as other bank customers who prefer to do business with a competitor of the parent? The answer, of course, is that it won't. The commercial parent will not want the bank to treat them the same; a bank owned by a commercial company will always want to make available as much credit as possible to the customers and suppliers of its parent so they do not shop or bank with competitors. Such a business strategy will pose significant risks to the financial system arise because a bank owned by a commercial firm may not have the freedom to exercise the discipline needed to make truly independent credit judgments.

Unlike Wal-Mart's stated purpose of wanting to use its ILC only for processing debit and credit card transactions, the Home Depot proposal has a significant and potentially more troubling twist. On May 9, 2006, Home Depot announced its agreement to purchase EnerBank to expand its "business and relationships" with home improvement contractors.<sup>4</sup> Home Depot's news release states,

"[t]his acquisition gives us the opportunity to offer our services to The Home Depot's large contractor customer base . . . . This growth opportunity and the

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<sup>4</sup> News Release, *The Home Depot to Acquire EnerBank USA*, <http://ir.homedepot.com/ReleaseDetail.cfm?ReleaseID=195724>.

resources of The Home Depot will also strengthen the high level of service we offer to our existing contractors and program sponsors.”<sup>5</sup>

When the contractor and the homeowner are negotiating a contract, the contractor will “tell the client to phone EnerBank” which will approve the loan. The EnerBank loan to the homeowner “starts” when the homeowner is satisfied that a contractor has completed the home improvement project and when the homeowner endorses an EnerBank check to the contractor. Home Depot’s [FDIC filed] Notice states:

The Home Depot believes that EnerBank’s ability to help contractors be more successful will strengthen The Home Depot’s affinity relationship with its contractor customers, and as a result, they will be more likely to purchase their materials from The Home Depot.<sup>6</sup>

This Home Depot business plan creates an inherent conflict of interest because Home Depot will have an incentive to encourage EnerBank to provide financial services to home improvement contractors that are Home Depot customers and not to other contractors, because that will help increase sales by Home Depot. An unlevel competitive playing field is a significant risk because EnerBank may be pressured to provide loans on favorable terms to prospective borrowers who use contractors with whom Home Depot has established relationships as a means of generating additional business for Home Depot. As a wholly-owned subsidiary of Home Depot, on which it presumably will be dependent for a substantial portion of its funding, the EnerBank will have a built-in bias towards favoring applicants who do business with contractors who are customers of its parent. The Home Depot plan, therefore, has the potential to expose EnerBank to substantial risk of losses because of this inherent bias and conflict of interest.

*Conflict with Transactions with Affiliates (TWA) Rule*

An additional concern raised by the proposal arises in connection with the application of Section 23A of the Federal Reserve Act, 12 U.S.C. 371c, and Federal Reserve Regulation W, 12 C.F.R.

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<sup>5</sup> *Id.*

<sup>6</sup> Interagency Notice of Change in Control filed by Home Depot on May 8, 2006, page 10.

Part 223, which limit “transactions with affiliates.” EnerBank, of course, is subject to the restrictions of Section 23A and Regulation W.<sup>7</sup> Loans made by EnerBank to customers of home improvement contractors that are customers of Home Depot will be transactions that will be subject to Section 23A and Regulation W because the proceeds of the transaction are used for the benefit of, or transferred to, Home Depot. The Notice suggests that restrictions on transactions with affiliates are addressed by the proposed policy that prohibits contractors from purchasing material with an EnerBank check in Home Depot stores.<sup>8</sup> The fact that Home Depot may benefit from, and perhaps receive the loan proceeds from, contractors indicates that Home Depot’s business plan is based upon a misconception of banking law. NAR has recommend that the FDIC consult with the Federal Reserve, the agency with rulemaking and interpretive authority for Section 23A<sup>9</sup>, regarding this matter. We have also asked the Federal Reserve to review the TWA issues raised by the Home Depot proposal and to ask the FDIC to suspend consideration of the proposed acquisition until the Federal Reserve has completed its review.

NAR believes the business plan of The Home Depot is flawed and accordingly, we oppose its Interagency Notice of Change in Control. As NAR has consistently stated over the years, we believe Congress should decide whether it is appropriate to permit the mixing of banking and commerce in circumstances such as these, not the regulators.

#### **Other Initiatives to Permit Banks into Commerce Should Also Be Blocked**

At the same time that numerous banking organizations and bank trade associations are strenuously opposing the Wal-Mart and Home Depot’s application on the basis that permitting commercial firms to own banks will result in an impermissible mixing of banking and commerce, they are themselves seeking to expand permissible bank activities into real estate brokerage, management, and real estate development—activities which by their very nature are commercial. NAR believes that the various government agencies involved should reverse any trend in this direction.

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<sup>7</sup> 12 U.S.C. 1828(j).

<sup>8</sup> Notice at page 10.

<sup>9</sup> 12 U.S.C. 371c(f).

In 2001, for example, the Federal Reserve Board and the Department of the Treasury published a proposed rule that would permit financial holding companies and financial subsidiaries of national banks to engage in real estate management and brokerage. NAR believes that these activities are commercial, and apparently Congress agrees, since it has blocked the agencies from issuing a final rule. More recently, the Office of the Comptroller of the Currency (OCC) has issued several rulings that, in our view, go beyond the statutory authority banks have to own real estate to accommodate their businesses. We think that permitting banks to develop and own luxury hotels and develop residential condominiums for immediate sale in order to make the remainder of a project economically feasible stretches the law to the breaking point. As in the case of the Wal-Mart deposit insurance application and the Home Depot Notice, we believe that Congress should resolve the irreconcilable clash of commercial and banking industries over these related issues, not regulatory agencies.

#### **Conclusion**

The National Association of REALTORS® commends Chairman Bachus and Representative Maloney for holding today's hearing on ILCs. NAR asks Congress to send a clear signal to the FDIC to delay action on all pending commercial companies' applications for federal deposit insurance for ILCs and processing Change in Control Notices for acquisition of ILCs. NAR further asks Congress to carefully consider whether to tighten or eliminate the loophole altogether. NAR stands ready to work with you on legislation that reinforces our national policy against mixing of banking and commerce to ensure continued stability and growth of the nation's financial system.

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THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

October 26, 2005

The Honorable Edward R. Royce  
U.S. House of Representatives  
2202 Rayburn House Office Building  
Washington, DC 20515-0539

Dear Ed:

I am writing in response to your October 18<sup>th</sup> letter related to legislation recently introduced in the U.S. House of Representatives. You asked the Commission to answer questions to help you and your Congressional colleagues better understand the consolidated supervised entity (CSE) regime. First, I will outline the context of the Commission's rules for the CSE regime, and then provide answers to your specific questions.

The consolidated supervised entity, or CSE, rules allow highly capitalized broker-dealers with strong internal risk management practices to utilize mathematical models already used to manage their own business risks for purposes of calculating their net capital requirements. These models generally recognize the risk-reducing effects of hedging, often resulting in lower capital charges for firms under the CSE rules as compared to the traditional net capital rule. Thus, this alternative method of computing net capital responds to firms' requests to align their supervisory risk management practices and regulatory capital requirements more closely. The CSE rules also respond to the European Union's Financial Conglomerates Directive, which requires financial conglomerates with operations in the EU to be subject to consolidated, group-wide supervision. Under the Directive, affiliates of U.S.-registered broker-dealers that conduct business in the EU must demonstrate that they are subject to consolidated supervision by a U.S. regulator at the holding company level that is "equivalent" to EU consolidated supervision by the end of 2005 or face significant restrictions on their operations in Europe. Accordingly, the CSE rules should minimize duplicative regulatory burdens on firms that are active in the EU.

The CSE rules are intended to help the Commission protect investors and maintain the integrity of the securities markets by improving oversight of broker-dealers and providing an incentive for broker-dealers to implement strong risk management practices. Furthermore, consolidated supervision should permit the Commission to monitor better, and act more quickly in response to, any risks that affiliates and the ultimate holding company may pose to the broker-dealer.

A broker-dealer that wishes to elect consolidated supervision by the Commission must submit a formal application for Commission approval. Among other items, the application must include a comprehensive description of the broker-dealer's internal risk management system; a

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description of the mathematical models to be used to price positions and to compute deductions for market and credit risk; and a written undertaking from the broker-dealer's ultimate holding company in which the holding company agrees to group-wide, consolidated SEC supervision. Before Commission action on a CSE application, the staff reviews the statistical models used for regulatory capital purposes, as well as the internal control regime in which these models are used. This review involves on-site meetings with firm personnel and off-site analysis of documents, reports and other materials. The Commission has approved three firms as CSEs: Goldman Sachs, Merrill Lynch, and Morgan Stanley.

**Question:** Does the Commission's oversight regime for CSEs allow it to examine the entity's risk management, internal controls, computer systems, or other operations on an enterprise-wide basis to identify systemic risks?

**Answer:** Yes. Under the Commission's CSE rules, the ultimate holding company must agree to comply with rules regarding the implementation and documentation of a comprehensive, group-wide risk management system for identifying, measuring, and managing risk to the enterprise, including, at a minimum, market, credit, liquidity, legal, and operational risk (operational risk involves risk arising from, among other things, processes and systems, including information technology systems). The Commission may examine the ultimate holding company and its affiliates (unless those affiliates already are subject to supervision by a federal financial regulator) for compliance with risk management and other rules.

Moreover, a CSE ultimate holding company must provide the Commission with monthly, quarterly, and annual reports. The monthly report must include specified consolidated financial and credit risk information, including a consolidated balance sheet and income statement; statements of allowable capital and allowances for market, credit, and operational risk; and certain reports that the ultimate holding company regularly provides to its senior management to assist in monitoring and managing risk.

The quarterly report must contain all of the information included in the monthly report, as well as consolidated balance sheets that provide information on each material affiliate, income statements, and other specified information. The quarterly report also must contain the results of all backtesting of models used to compute allowable capital and allowances for market and credit risk and indicate the number of backtesting exceptions.

The CSE rules require the ultimate holding company to file an annual audited report with the Commission within 65 calendar days of the end of its fiscal year. The annual report must include consolidated financial statements for the ultimate holding company audited by a registered public accounting firm. The financial statements must include a supporting schedule containing statements of allowable capital and allowances for market, credit, and operational risk, as well as the results of a registered public accounting firm's review of the ultimate holding company's compliance with Rule 15c3-4, which contains requirements for internal risk management control systems.

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Finally, the CSE rules impose certain recordkeeping requirements on the ultimate holding company. The ultimate holding company must make and keep current records of funding and liquidity stress tests and calculations of allowable capital and allowances for market, credit, and operational risk, among other things.

**Question:** Can the Commission take action with respect to activities that jeopardize the financial stability of the holding company or affiliates?

**Answer:** Yes. The CSE rules permit a broker-dealer that meets specified criteria to calculate certain of its capital requirements using internal models. As a condition to use of these internal models, a broker-dealer must submit an undertaking from its ultimate holding company in which the holding company agrees to Commission supervision and to comply with the applicable provisions of the CSE rules. If an ultimate holding company that does not have a principal regulator (that is, it does not already have a consolidated supervisor) experiences financial or operational difficulty, the Commission may increase certain multiplication factors on the holding company's capital requirements; require it to file more frequent reports; require it to modify its group-wide internal risk management control procedures; or impose additional conditions that the Commission finds are necessary or appropriate in the public interest or for the protection of investors. The Commission also may impose conditions on the CSE broker-dealer if its ultimate holding company is experiencing financial or operational difficulty. Those conditions could include requiring the broker-dealer to increase its net capital, file more frequent reports with the Commission, or modify its internal risk management control procedures. The Commission also could revoke the broker-dealer's ability to use internal models to calculate capital requirements in an extreme case.

**Question:** Does the Commission's oversight of these entities permit the Commission to examine holding company affiliates that may not have business relationships with the industrial bank affiliate?

**Answer:** Yes. Under the CSE rules, the ultimate holding company must permit the Commission to examine the ultimate holding company and each of its affiliates, except those affiliates already subject to supervision by a federal financial regulator. The Commission, for example, would not examine a futures commission merchant affiliate regulated by the Commodity Futures Trading Commission or an ILC affiliate subject to the Federal Deposit Insurance Corporation's oversight.

**Question:** Are consolidated supervised entities subject to capital standards?

**Answer:** Yes. As part of its reporting requirements, the ultimate holding company must compute, on a monthly basis, group-wide allowable capital. The CSE rules outline which of its assets the holding company may include as allowable capital. The ultimate holding company also must calculate and report on a monthly basis allowances for market, credit, and operational risk in accordance with the standards adopted by the Basel Committee on Banking Supervision. Moreover, ultimate holding companies are expected to maintain a minimum ratio of allowable capital to risk-weighted assets of 10 percent.

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If you have any questions or if we can be of further assistance, please do not hesitate to contact me at (202) 551-2100, or have your staff contact Jane Cobb, Director of Legislative Affairs, at (202) 551-2010.

Sincerely,  


Christopher Cox  
Chairman

**STATEMENT OF THOMAS J. BLILEY, JR.**

**on behalf of**

**THE SOUND BANKING COALITION**

**THE HOUSE FINANCIAL INSTITUTIONS AND CONSUMER CREDIT  
SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVICES COMMITTEE**

**ILCs – A REVIEW OF CHARTER, OWNERSHIP, AND SUPERVISION ISSUES**

**July 12, 2006**

This statement is submitted on behalf of the Sound Banking Coalition (the Coalition) in connection with the House Financial Institutions and Consumer Credit Subcommittee's hearing regarding industrial loan companies (ILCs). We appreciate the opportunity to submit this statement and thank Chairman Bachus, Ranking Member Sanders and the members of the Subcommittee for holding a hearing on this important issue. In addition, we would like to thank Representative Gillmor and Ranking Member Frank for introducing the Industrial Bank Holding Company Act of 2006. The legislation will go a long way toward correcting the problems caused by the industrial bank loophole, and the Coalition supports it wholeheartedly.

The Sound Banking Coalition is a group of concerned organizations that have come together to try to close the industrial loan company (ILC) loophole to protect consumers and businesses from the problems and the threat to FDIC insurance posed by ILCs. The members of the Sound Banking Coalition are the Independent Community Bankers of America, the National Association of Convenience Stores, the National Grocers Association, and the United Food and Commercial Workers International Union. The members of the Coalition recognized the potential problems posed by the ILC loophole years ago and organized the group in 2003, when there were few applicants for ILC charters.

**The ILC loophole allows the mixing of banking and commerce and prevents rigorous supervision of ILC holding companies, threatening the banking system and the federal deposit insurance fund.**

In 1987, Congress created a loophole in the federal banking laws that said some banks – specifically, industrial banks – were not banks at all for purposes of federal law.<sup>1</sup> This loophole cut against a fundamental principle of U.S. banking law that has been emphasized by most states and the U.S. Congress – the separation between banking and commerce. When the loophole was created it was not particularly significant because industrial banks were very small, local institutions. Now, however, industrial banks have aggressively expanded their powers and have grown to the point that deposits reach into the billions of dollars and several large corporations own and operate industrial banks. The lack of consolidated supervision of these institutions and the mixing of banking and commerce that occurs when a commercial entity owns a bank threaten some of the basic underpinnings of banking regulation in the United States and could have a significant impact on Coalition members, consumers, and the financial services marketplace as a whole.

The United States has historically kept banking and commerce separate. There are two basic reasons for this approach. One is fairness. Banks are supposed to be neutral arbiters of capital. When banks are owned by commercial entities, however, conflicts of interest can skew loan decisions, unfairly restricting access to capital. This leads to the second reason: safety and soundness. The temptation to favor or discriminate against borrowers (or potential borrowers) based on commercial concerns rather than sound lending principles can lead to systemic problems not only for those seeking capital who are wrongly denied, but also for the financial institutions themselves. FDIC insurance would face significant exposure if the company is granted a bank charter. To the extent the bank or the parent company experienced financial problems, the losses to FDIC insurance could be very large. This is not just a philosophical exercise: Japan provides an explicit example of the dangers of mixing commerce and banking.

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<sup>1</sup> Industrial banks are also known as industrial loan companies (ILCs).

There are a number of ways an ILC can be negatively affected by a commercial parent company:

- financial trouble at the commercial parent or a commercial affiliate can impair the ILCs ability to access necessary capital and credit sources in the financial sector;
- inappropriate inter-company transactions such as excess dividends, manipulation of interest rates, and inappropriate loans, can drain the ILC's capital/profits;
- reputational harm; and
- operational risks from information sharing within the corporate family.

These risks are particularly significant because industrial banks are not subject to the same level of regulatory oversight as banks: they do not face the same consolidated supervision at the holding company level, they do not be subject to consolidated capital requirements, and would be subject to arguably weaker regulatory enforcement. This leaves insufficient safeguards to ensure that this massive company will not endanger FDIC insurance. We question the rationale for this differential treatment of ILCs. As the GAO recently reported to Congress, ILCs “pose similar risks to the bank insurance fund as other types of insured depository institutions.” In fact, the same GAO report went further, stating that “from a regulatory standpoint, these ILCs may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company.”

- **Consolidated Holding Company Supervision:** Unlike bank holding companies, ILC holding companies are not subject to consolidated holding company supervision. Although the ILC itself is subject to FDIC oversight, the FDIC has more limited regulatory powers with respect to holding companies and affiliates than does the Federal Reserve. The Bank Holding Company Act (BHCA) provides the Federal Reserve with the authority to examine the bank holding company itself and any of its non-bank subsidiaries at any time, while the FDIC has only limited examination authority, and is unable to examine affiliates of

banks unless necessary to disclose the direct relationship between the bank and affiliate and the effect of the relationship on the bank.<sup>2</sup>

- **Consolidated Capital Requirements:** The Federal Reserve is also entitled to establish consolidated capital requirements to ensure that bank holding companies are a source of financial strength for the subsidiary bank. This source of strength doctrine has been codified in Regulation Y, which specifies that a bank holding company parent should be ready to provide capital to its bank subsidiary when needed. Failure to provide such assistance would enable the regulator to take enforcement action to protect the bank. In contrast, corporate parents of ILC's are not subject to these capital requirements.
- **Enforcement:** Finally, the Federal Reserve has broad enforcement authority under the BHCA, and can issue cease and desist orders, impose civil penalties, and order a holding company to divest non-bank subsidiaries if it determines that ownership of the subsidiary presents a risk to the financial safety, soundness, or stability of an affiliated bank and is inconsistent with sound banking principles or the purposes of the BHCA.<sup>3</sup> The Federal Reserve is the only federal agency authorized to take such actions against bank holding companies.

The safeguards provided by Federal Reserve regulation are necessary to protect the FDIC insurance against the potential risks presented by a ILC holding companies. Without these safeguards, it may be impossible for problems to be identified and managed in time to prevent deficiencies and damage to the federal safety net. As more and more commercial entities apply for – and are granted – ILC charters, this risk grows ever greater. Simply stated, this is a risk that United States taxpayers should not be forced to take.

The Federal Reserve on numerous occasions has opined on the threat posed by ILCs to the banking system and the insurance fund. In testimony before the Financial Services

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<sup>2</sup> Letter to Senator Tim Johnson from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, June 25, 2003, at 4.

<sup>3</sup> *Id.* at 5.

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Committee in February of this year, newly-appointed Federal Reserve Board Chairman Ben Bernanke urged Congressional review and action with respect to the regulation of ILCs.

The Board's current policy is clearly consistent with the views of former Board Chairman Alan Greenspan. In a letter to Representative James Leach (R-IA) on January 6, 2006, Chairman Greenspan described the current and growing threat to the nation's financial system posed by ILCs.

When this exemption was adopted in 1987, ILCs were mostly small locally owned institutions that had only limited deposit-taking and lending powers. However, much has changed since 1987 and recent events and trends highlight the potential for this exemption to undermine important general policies established by Congress that govern the banking system and to create an unlevel competitive playing field among banking organizations. The total assets held by ILCs have grown by more than 3,500 percent between 1987 and 2004, and the aggregate amount of estimated insured deposits held by ILCs has increased by more than 500 percent since 1999.

The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption. These changes are undermining the prudential framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision. These are crucial decisions that should not be made

through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of states.

There is a temptation to assume that because a company is large and well known, and has many assets, it is safe. We have seen this assumption proven wrong time and time again. In fact, if anything, U.S. economic history has often shown that a far different adage typically holds sway – the bigger they are, the harder they fall. Enron, Worldcom, and Kmart provide recent examples. In fact, the latest example is playing out before our eyes as we watch General Motors lose billions of dollars each year and dramatically cut its workforce to try to stay solvent. Fifty years ago no one would have believed that GM would be in the difficult situation it is in today. What will this mean for GM's ILCs? Without regulation by the Federal Reserve that is very hard to say. Perhaps the ILCs are sound and will remain so for years to come – but perhaps not. The problem is that no one really knows because even though GM owns more than one bank it is not subject to consolidated supervision. We are left to wait and see what the future holds. These examples do make one thing clear – size and large revenues do not guarantee safety.

The depth and breadth of the concern about the ILC loophole generally has radiated across the country. In the absence of federal leadership, states are taking matters into their own hands. In part, this is due to Wal-Mart's application for an ILC charter, but it reflects an underlying unease with the steady expansion of ILCs under the loophole. Nearly a dozen states have adopted or are considering legislation that would block or limit ILC holding companies from using ILC charters to open bank branches within their borders. In Iowa, Virginia and Maryland, new laws ban ILC branches on the premises of a commercial affiliate. Laws in Vermont and Wisconsin prohibit ILCs from doing any business in their states. Similar legislation is pending in Illinois and Missouri. Michigan and Pennsylvania have legislation that would specifically bar branches of ILCs chartered in Utah. Kentucky and New York are

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considering similar legislation. This state activity is indicative of nationwide concerns about this issue.

The state-by-state attention to the issue is not likely to abate, particularly in light of the recently-enacted law in Utah which validates contract language in which borrowers waive their rights to participate in class actions against lenders. This law may be used to cut-off consumer rights not only in Utah, but in other states in which Utah financial institutions do business. In addition, Utah is one of approximately 12 states that has removed the usury ceiling for consumer loans.

The surge of state activity on this issue – and the variety of approaches taken by the states to address the problem – are yet another indication that Congress needs to join this debate. We are encouraged by the introduction this week of the Industrial Bank Holding Company Act by Congressmen Gillmor and Frank. The bill takes a common-sense approach to addressing the huge growth of ILCs and the real threat posed to the safety and soundness of the financial system when these institutions are controlled by commercial entities.

Again, thank you for the opportunity to submit this statement regarding industrial loan company oversight and the ILC loophole. Congressional action on this issue is critical in order to avoid serious threats to competition, the federal deposit insurance fund, and consumer protections. The Gillmor-Frank legislation offers an excellent opportunity to fix the ILC loophole before the threats become major problems.

Thomas J. Bliley, Jr.  
The Scott Group, PLLC  
3050 K Street, NW Suite 400  
Washington, DC 20007  
202-342-8429  
tbliley@thescottgroupdc.com



**NCRC Statement on Industrial Loan Companies  
Submitted to the House Financial Services Committee  
July 10, 2006**

The National Community Reinvestment Coalition (NCRC) greatly appreciates the opportunity to submit a comment for the public record concerning Industrial Loan Companies (ILCs). NCRC agrees with several members of Congress that the ILC loophole needs to be closed completely.

NCRC is the voice for 600 community organizations members representing millions of low- and moderate-income consumers across America. We are the nation's economic justice trade association dedicated to increasing access to credit and capital for minority and working class families.

***Banking & Commerce Do Not Mix***

By allowing ILCs (industrial loan company) to exist, federal regulators would let companies like Wal-Mart have the same privileges as a regular bank without the same rigorous regulatory oversight. Unlike other banks, ILCs fly under the radar of federal regulating agencies. They are exempt from the Bank Holding Company Act (BHCA), which requires safety and soundness examinations of banks and their parent companies. Without these protections, the U.S. banking system and taxpayers who fund the federal safety net for banks and ILCs are put at serious risk. Major corporate scandals, such as Enron and Worldcom, highlight potential financial failures that Wal-Mart could similarly engender. If Enron had been an ILC, the U.S. banking system and American taxpayers would have had to foot the bill. Imagine the implications given that Wal-Mart does more business than Target, Sears, Kmart, JC Penney, Safeway and Kroger combined.

Mixing banking and commerce imperils safety and soundness because it eliminates a bank's impartiality. A bank with a commercial affiliate will not base its lending decisions on sound underwriting criteria. Instead, it will favor its affiliate and cut off credit for its competitors. The bank will also be tempted to finance its affiliate's speculative and risky ventures. With a bank the size of Wal-Mart or Home Depot, the end result is a significant reduction in credit for independent small businesses, and an increase in financing for the bank's affiliate, regardless of the risk it produces.

Victims of predatory lending have also fallen prey to abusive home improvement loans. The business model proposed by Home Depot would create incentives for contractors to aggressively market home improvement loans to unsuspecting customers, thereby exacerbating current predatory lending and home improvement scams. Current ILC loopholes do not provide comprehensive oversight to address these potential issues.

While many ILCs start as special purpose banks processing credit cards, they can quickly amass a sizable amount of profits and capital. Where would a Wal-Mart invest these profits and capital? It is likely these investments would be anti-competitive and could also be risky.



While companies like Wal-Mart may point out that they are not alone in their attempts to establish ILC's, this does not rectify the fact that they exploit an outdated and already abused loophole. NCRC and other consumer advocate organizations support the complete elimination of the ILC loophole and have petitioned Congress to close the loophole as it considers regulatory relief provisions.

ILCs were never intended to be large, nationwide banks that offered services indistinguishable from commercial banks. In 1987, Congress granted an exception to the BHCA for ILCs because they were sporadically chartered in a small number of states, held very few assets, and were limited in the lending and services they offered. In fact, the exception applied only to ILCs chartered in five states (Utah, California, Colorado, Nevada, and Minnesota) which either have assets of \$100 million or do not offer checking services. Yet since that time, everything about ILCs has grown: the number that exist, the amount of assets and federally insured deposits in them, and services and lending products they can offer.

According to the General Accounting Office (GAO), ILC assets grew from \$3.8 billion to over \$140 billion (over 3,500%) between 1987 and 2004. Of the 180 largest financial institutions in the country, in 2004, six were ILCs with \$3 billion each in assets. According to the Federal Reserve, the majority of ILCs had less than \$50 million in assets in 1987, with assets at the largest ILC valuing less than \$400 million. By contrast, in 2003, one ILC owned by Merrill Lynch had more than \$60 billion in assets (and more than \$50 billion in federally insured deposits).

It is time to shut down this parallel banking system, and disallow its further expansion. The Federal Reserve Board has also recommended that the ILC exemption be eliminated. NCRC and its members strongly urge the FDIC to reject pending applications to establish ILCs, and call on Congress to close the ILC loophole permanently.

### ***Conclusion***

Today, with the existing loophole, the world's largest retail corporation could gain banking privileges that Congress never intended for it to have; it would be given insufficient regulatory oversight due to an exemption from the Bank Holding Company Act, and it would only need to meet the bare minimum obligations to low- and moderate-income communities under the Community Reinvestment Act. As a result, American taxpayers and the U.S. banking system will be put at risk. The health of community banks, small businesses, and the product choices they offer consumers would be jeopardized.



Office of Thrift Supervision  
Department of the Treasury

John M. Reich  
Director

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6590

July 11, 2006

The Honorable Spencer Bachus  
Chairman  
Subcommittee on Financial Institutions  
and Consumer Credit  
Committee on Financial Services  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

As you evaluate the structure and supervision of the industrial loan company (ILC) segment of the financial services industry, it is important to clarify the Office of Thrift Supervision's (OTS) existing supervisory authority in this area.

Some have suggested that ILC's and their holding companies are unregulated and that ILC's in holding company structures pose potential risks arising out of the relationship, transactions and activities between the ILC and its parent holding company. It has been further suggested that these risks may only be managed by subjecting the corporate parent of an ILC to supervision as though it were a bank holding company. In fact, there is a regulatory structure already in place in which a number of ILC holding companies are currently subject to holding company oversight.

In any instance where an ILC and a savings association are affiliated in a corporate structure, the holding company is a savings and loan holding company subject to regulation by the OTS. In such cases, the state is the primary regulator of the ILC, the FDIC is the appropriate federal banking agency for the ILC, and the OTS is the appropriate federal banking agency for the ILC holding company, as well as the affiliate savings association.

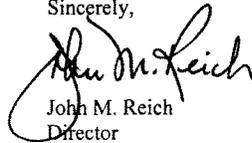
The notion that only a bank holding company framework provides rigorous holding company oversight is mistaken. The OTS has long exercised broad and effective oversight of complex holding company structures that own savings associations. OTS currently supervises 481 thrift holding companies with aggregate assets of \$7.5 trillion. Eight of these companies also own an ILC and, as such, are subject to OTS holding company jurisdiction and oversight. These OTS-supervised holding companies control approximately 70 percent of the total ILC assets nationwide, and include Merrill Lynch, Morgan Stanley, USAA, American Express, Lehman Brothers and General Electric.

Page 2

Authority for OTS to supervise these depository holding company structures under the Home Owners Loan Act is comprehensive. This authority is recognized not only domestically, but also internationally by the European Union, which has recognized OTS as a consolidated coordinating supervisor for General Electric, an OTS-supervised holding company conglomerate that operates in the EU.

As you consider legislation involving oversight of the ILC industry, please feel free to contact us with any questions you may have with respect to OTS's experience, holding company supervisory authority and oversight. My staff and I are also available to assist you in any manner regarding legislation in this area. Thank you.

Sincerely,

A handwritten signature in black ink, appearing to read "John M. Reich". The signature is fluid and cursive, with the first name "John" being particularly prominent.

John M. Reich  
Director

cc: Members of the Subcommittee on  
Financial Institutions and Consumer Credit

**Congress of the United States**

Washington, DC 20515

June 8, 2006

The Honorable Martin J. Gruenberg  
Acting Chairman  
Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429

Dear Chairman Gruenberg:

We urge the Federal Deposit Insurance Corporation to impose a moratorium on approving any applications for deposit insurance for any new industrial loan companies (ILCs) owned by commercial firms and on approvals for acquisitions of existing ILCs until Congress has had an opportunity to consider the ILC issue.

As you know, the House has twice this Congress and once last Congress passed provisions authored by Congressmen Gillmor and Frank that would restrict the authority of ILCs who come under the control of commercial firms after October 1, 2003 to engage in certain activities, specifically nationwide branching and paying interest on business negotiable order of withdrawal accounts. Some Members of Congress will soon be introducing legislation that will address the ILC issue in a comprehensive manner and as you know, last year Congressman Leach introduced HR 3882, a bill that would prohibit ownership of ILCs by any firm other than a bank holding company.

Further evidence that Congress is moving to address the issue are press reports that Chairman Bachus of the Financial Institutions Subcommittee has said that the subcommittee will hold hearings on the ILC issue later this year.

Over the past several years the number of commercial firms seeking to obtain an ILC charter has grown at an ever-increasing pace. What was once a minor exception to the general separation of banking and commerce has grown into an industry unto itself, with ever-larger commercial and retail firms seeking to obtain an ILC charter. While many of these firms say that they want to own an ILC for very narrow purposes, and file narrow business plans with their applications, it is not clear that the FDIC has the legal authority to permanently prevent them from engaging in activities that are permitted by their chartering state, so long as they remain well-capitalized and operate in a safe and sound manner. The issue of the powers of ILCs, and the extent of who may own an ILC, is an issue that Congress has begun to address, and the FDIC should wait until Congress has acted before authorizing any additional commercially-owned ILCs.

Sincerely,

  
PAUL GILLMOR

  
BARNEY FRANK

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MICHAEL MICHAUD

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KAY GRANGER

*Kenny Marchant*  
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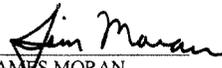
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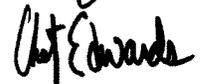
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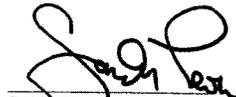
  
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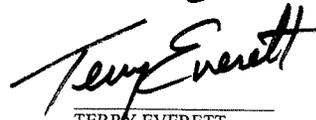
  
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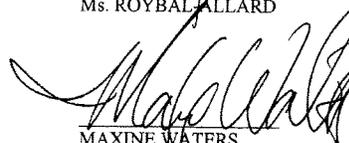
  
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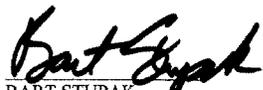
  
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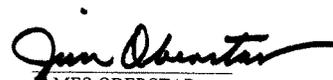
  
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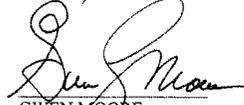
  
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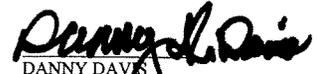
  
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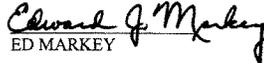
  
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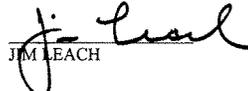
  
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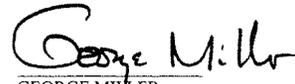
  
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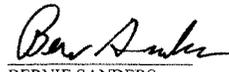
  
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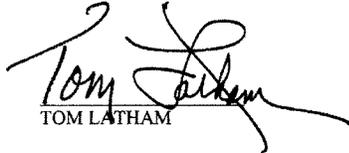
  
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*Adam Schiff*  
ADAM SCHIFF

**U.S. House of Representatives  
Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, DC 20515**

December 15, 2005

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 The Honorable Martin J. Gruenberg  
 Acting Chairman  
 Federal Deposit Insurance Corporation  
 550 17th Street, NW  
 Washington, DC 20429

Dear Chairman Gruenberg:

As concerned members of the House Committee on Financial Services, we urge the Federal Deposit Insurance Corporation to defer any decision on the application for federal deposit insurance filed by Wal-Mart Bank until the Board has its full complement of directors. This application is clearly of sufficient importance to require that it be made by the members of the FDIC Board itself and only by a full Board without vacancies. We ask for your commitment that the decision will be deferred at least until the Board is once again at full strength.

On September 23, 2005, Ranking Member Frank and Congressman Gillmor wrote to then-Chairman Powell urging the FDIC to hold public hearings on the application, and we renew that request today. While FDIC regulations in 12 CFR 303.10(c), appear to leave the determination of whether to hold public hearings to the discretion of the regional director, we urge that you exercise your authority as Chairman to require that public hearings be held on the Wal-Mart Bank application. As you know, this application has generated historic levels of interest, with the FDIC receiving more than 1000 written comments. We believe that the extensive number of comments received by the FDIC supports the need for public hearings, rather than be used as a reason why public hearings should not be held. The FDIC regulation states one of the grounds on which to hold public hearings is whether the hearings "would be in the public interest."

Given the reluctance of the FDIC to release additional information concerning the non-public portion of Wal-Mart Bank's business plan and given the numerous requests for public hearings that the FDIC has received, hearings would clearly be in the public's interest.

Sincerely,

  
 REP. PAUL E. GILLMOR  
  
 REP. JAMES A. LEACH

  
 REP. BARNEY FRANK  
  
 REP. PAUL E. KANJORSKI

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*Sue Kelly*

REP. SUE W. KELLY

*Steve LaTOurette*

REP. STEVEN C. LaTOURETTE

*Chris Shays*

REP. CHRISTOPHER SHAYS

*Gary G. Miller*

REP. GARY G. MILLER

*Katherine Harris*

REP. KATHERINE HARRIS

*Geoff Davis*

REP. GEOFF DAVIS

*Barbara Lee*

REP. BARBARA LEE

*Wm. Lacy Clay*

REP. Wm. LACY CLAY

*Stephen F. Lynch*

REP. STEPHEN F. LYNCH

*Debbie Wasserman Schultz*

REP. DEBBIE WASSERMAN SCHULTZ

*Carolyn B. Maloney*

REP. CAROLYN B. MALONEY

*Nydia M. Velazquez*

REP. NYDIA M. VELAZQUEZ

*Garry L. Ackerman*

REP. GARY L. ACKERMAN

*Darlene Hooley*

REP. DARLENE HOOLEY

*Julia Carson*

REP. JULIA CARSON

*Brad Sherman*

REP. BRAD SHERMAN

*Michael E. Capuano*

REP. MICHAEL E. CAPUANO

*Carolyn McCarthy*

REP. CAROLYN MCCARTHY

*Emanuel Cleaver*

REP. EMANUEL CLEAVER

*Gwen Moore*

REP. GWEN MOORE

*Bernard Sanders*

REP. BERNARD SANDERS

Questions Submitted for the Record  
Congressman Paul E. Gillmor (R-OH)  
Subcommittee on Financial Institutions and Consumer Credit  
July 12, 2006

Hearing entitled: "ILCs—A Review of Charter, Ownership, and Supervision Issues"

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**Rick Hillman:**

- 1) Could you please provide for the Committee a list of ILC parent-companies that would be affected by the restrictions on branching provided in H.R. 3505? What commercial and financially-owned ILCs currently in existence are engaged in interstate branching?

GAO did not pursue this issue as part of the scope of work for its ILC report and therefore does not have the information to respond to this question.

**CALLISTER, NEBEKER & McCULLOUGH**

ATTORNEYS AND COUNSELORS  
Gateway Tower East Suite 900  
10 East South Temple  
Salt Lake City, Utah 84133  
Telephone 801-530-7300  
Fax 801-364-9127  
Sender's direct 801-530-7343  
Sender's e-mail: gsutton@cnmlaw.com

George R. Sutton

August 10, 2006

Rep. Paul E. Gillmor  
1203 Longworth House Office Building  
Washington, D.C. 20515

Re: Response to your questions at hearing titled "ILCs—A review of Charter, Ownership and Supervision Issues" on July 12, 2006

Dear Representative Gillmor,

I am pleased to respond to the questions you directed to me during and following the hearing on July 12 hearing before the Subcommittee on Financial Institutions and Consumer Credit regarding industrial banks.

*Q. 1 In an article published in the Consumer Finance Law Quarterly Report in the Spring of 2002, you list some of the primary advantages of an industrial bank like the ability to operate under "generally less intrusive laws and regulations". Do you believe that the promotion of a particular charter based on weak regulation is to the benefit of our financial system? In what instances do you find the regulation of Bank Holding Companies to be intrusive or unnecessary?*

There is a difference between "weak" regulation and "generally less intrusive" regulation. Nothing in my writings or the legal regime governing industrial banks suggests that the regulatory structure governing these banks and the firms that own them is weak. I have never promoted any charter on the basis of weak regulation and would not condone anyone else doing so. As a former regulator, I understand the potential consequences of weak regulation and fully support the stronger regulatory model used to regulate industrial banks.

My 2002 article noted that "[a]n industrial bank holding company is not subject to the penalties applicable to a financial holding company if a subsidiary bank suffers a capital impairment or receives a less than satisfactory Community Reinvestment act (CRA) rating." This is an accurate description of the law. Like all bank holding companies that have not elected to become "financial holding companies" and savings bank holding companies, industrial bank holding companies are not required by statute to sell or close a bank subsidiary or discontinue other activities if a bank subsidiary fails to maintain specific CRA ratings, capital levels or management ratings. The

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banks are still required to solve any such problems if they occur and failing to do so could in an extreme case result in a forced closure of the bank or sale of the bank to new owners that will solve the problems. Fortunately, this problem has never arisen in practice. As a group, industrial banks have capital ratios substantially higher than banks generally and all have CRA ratings of outstanding or satisfactory. Approximately 40% of those have been rated "Outstanding", a record of achievement that is substantially better than banks generally.<sup>1</sup> I am aware of one instance where an industrial bank received a less than satisfactory management rating and as a result the bank's CEO was terminated a short time later and the new management has a satisfactory rating or better.

These unique penalties applicable to a financial holding company present certain practical concerns. 12 U.S.C. § 1843(m)(4) provides that if a financial holding company's subsidiary bank fails to cure a bad CRA or management rating or a capital impairment within 180 days, the financial holding company must either (1) close the bank, (2) divest the bank or (3) terminate all activities not permitted for a bank holding company (which could include forced divestiture of insurance and securities affiliates). Some holding companies were concerned that if their bank received a bad CRA or management rating (perhaps the result of a close call by an overly aggressive examiner) a new examination could not be performed within the 6 month deadline even if the deficiency prompting the original rating had been rectified. This would be especially true if it took most of the six months to resolve that problem, for example by implementing a new CRA program or recruiting a new CEO. In the first few years after the Gramm-Leach-Bliley Act passed, advisors across the nation were cautioning holding companies about this risk because of practical concerns about resolving any deficiencies that might occur before they would be required to divest or close the bank or terminate other permissible activities.

As noted above, these penalties do not apply to any bank or other kind of holding company. With regard to capital, management and CRA ratings, an industrial bank is subject to the same standards, requirements and supervisory powers as all other banks, and an industrial bank holding company is subject to the same standards and remedial actions applicable to a bank holding company or a savings bank holding company.

The reference to "intrusive laws and regulations" in my article related to provisions of the Bank Holding Company Act that I personally consider *unnecessarily*

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<sup>1</sup> Obtaining an "Outstanding" CRA rating is not easy. I noted, for example, that the witnesses who testified on behalf of the American Bankers Association and the Independent Community Bankers Association in opposition to the ILC charter at the recent hearing are presidents of banks whose institutions were rated "Satisfactory" in their most recent examinations. Similarly, the credit card bank operated by ICBA was rated "satisfactory" in its most recent examination.

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intrusive. I would include in that category the activities restrictions applicable to holding companies and affiliates in the Bank Holding Company Act and the regulation of affiliates that have no connection with a bank controlled by a common parent.

My views in that regard agree completely with a study published by the FDIC in 1987 entitled "Mandate for Change." That study found the Bank Holding Company Act unnecessary and counterproductive. The following excerpt summarizes the FDIC's findings:

... Several conclusions emerge from this [study]. ... there appears to be no historical precedent to suggest that there is a long standing tradition of separation of banking and commerce in the United States. Beyond historical precedent, our review of the evidence does not support the wisdom of separation and thus we find no compelling reasons for continuing it.

Perhaps most importantly, the analysis does not support the view that product limitations and regulatory or supervisory authority over nonbanking affiliates of banks are necessary to protect the stability of the system or limit the exposure of the deposit insurer or the payments system. ...

... systemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over non-bank affiliates are abolished. [emphasis in the original]. *FDIC, Mandate for Change, pages 98 and 102.*

Based on my 23 years of experience in banking regulation, I can see no need or benefit in regulating non banking affiliates that have no connection with the bank other than common ownership. A good example is a client that is a successful sixty year old finance company that organized an industrial bank in Utah instead of a commercial bank in its home state because it has an affiliate that does advertising for the industry it primarily serves. The advertising company is successful and profitable and the holding company saw no good reason to sell or close it just because the holding company was forming a bank. There is no inherent risk to the bank in being affiliated with that advertising company. If there were a risk, the regulators of the industrial bank have the authority to require the holding company to resolve the risk even if that means divesting the advertising company. Requiring a holding company to divest the advertising company without any finding of risk is unnecessarily and unjustifiably intrusive and that is what I was referring to in my article. In my experience, the absence of inherent risk in non banking affiliates is the rule, not the exception. I do not consider eliminating arbitrary restrictions to be weak regulation.

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Q. 2. *In the same 2002 article, you mention that another factor which separates industrial banks from traditional banks is the ability to offer "specific financial products and services to established customers of the parent or affiliates across the nation." You go on to mention that "the primary force driving the [industrial bank] industry is the opportunity to leverage existing customer relationships . . ." Could you please expand on your theory that this does not constitute tying?*

The anti tying provisions in the Bank Holding Company Act and implementing guidelines published by the Federal Reserve apply to industrial banks to the same extent as all other banks. The law itself does not outlaw all tying. It prohibits a bank from requiring the purchase of a non bank product from the bank or an affiliate to get a loan or other product from the bank. It does not restrict offering customers an array of products and services and the attendant benefits of "one stop shopping" and volume pricing. Indeed, one of the purposes of the Gramm-Leach-Bliley Act was to facilitate cross marketing and enable a bank and its affiliates to offer consumers a wide variety of services.

I am not aware of any effort by industrial banks generally or individually to repeal, weaken or obtain exemption from the anti tying laws. The FDIC and state regulators are particularly sensitive to tying issues in their examinations and the industrial banks I work with take care to ensure that their programs comply with the law. I am not aware of any instance where an examination found that an industrial bank had engaged in illegal tying.

What I described in my article is the kind of marketing that drives most businesses. Existing customer relationships is one of the most important assets of any business and building on that relationship is fundamental to the growth of many companies.

I first began to see the power in leveraging customer relationships when I was a regulator. That was during the worst of the savings and loan crisis. The agency I worked for subscribed to a rating service that rated every depository institution in the nation on a scale of 1 to 300. 300 was the top score. 1 basically meant the institution was still open but was insolvent and had already failed. Institutions rated 50 or below were failing and unlikely to survive. One day I got the latest ratings on savings and loans and reviewed the institutions in Texas which had become notorious for S&L failures. I found there were several hundred rated savings and loans in Texas. Of those, one third were rated 1 and two thirds were rated below 50. It was a disaster comparable only to the Great Depression. One institution stood out on the other end of the scale. It was a \$12 billion federal savings bank rated 300. I investigated and found that it was a real bank whose parent was a Texas based insurance company

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that operated nationwide. Both the bank and the parent had the highest ratings for financial strength and customer satisfaction. I eventually found a Forbes article that said the insurance company organized the bank after doing routine customer surveys that resulted in a large number of responses saying that customers liked the company, thought it offered good products at fair prices, and requested additional products including banking and mutual funds. The parent found that it could respond to this demand by organizing a single savings and loan. The first product offered by the bank was a standard MasterCard credit card. A normal credit card mailing is successful if the issuer gets a 1% response. The bank geared up for what it thought was an optimistic goal of a 10% response because it was mailing invitations to its parent's insurance customers. The first mailing went to 250,000 customers and nearly overwhelmed the bank when it got a 52% response. That customer loyalty is what built the bank and helped make it as close to perfectly safe and sound as a bank could be when most of the other banks in the state were in a death spiral. I checked further and found that there were only 6 savings and loans in the nation rated 300.

It particularly struck me at the time that this Texas savings and loan was the model for what a bank should be—financially sound, well liked by its customers, and stable in all economic conditions *but it could not be a commercial bank because of the restrictions in the Bank Holding Company Act*. Prohibiting that institution from being a bank turned the regulatory system on its head. It was a good example of how the Bank Holding Company Act imposed unnecessary and arbitrary restrictions on holding company activities and why Congress repealed the restrictions on affiliations between banks, insurance companies and securities companies in 1999.

The insurance company and its subsidiary bank did not engage in illegal tying by offering both insurance and banking products to its members. Tying is illegal when a bank requires a customer to purchase one or more banking products in order to obtain a non bank product from an affiliate or vice versa. The insurance company and bank simply offer a menu of products from which customers can choose and the business grows naturally from that demand.

This is how many industrial banks operate. They offer financial products and services to people who already have a customer or other relationship with an affiliate. For example, securities company affiliated banks offer deposits, commercial loans, real estate loans and credit cards to customers of the broker dealer affiliate. The customers request and in some instances demand those products and services and are free to choose or not choose any of them. Offering these products and services is a natural and powerful way to expand and develop the business and does not constitute tying in either form or substance.

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What does not work for an industrial bank is financing purchases from an affiliate with deposits. All such loans are covered transactions under section 23A of the Federal Reserve Act. Covered transactions must either be immediately sold without recourse or collateralized dollar for dollar with a pledged cash deposit in the bank. In addition, section 23B prohibits any preferential pricing or other below market incentives for a covered transaction.

Some forms of tying are beneficial to customers. Many businesses offer customers discounts on one product if the customer buys another. There is nothing inherently wrong with that but banks, including industrial banks, cannot engage in such practices unless they are tying two bank products such as waiving safe deposit box fees for customers that keep a minimum amount on deposit in the bank. No retailer or manufacturer owned bank can require a loan customer to buy products from the bank's affiliates or even offer an incentive to do so without violating the anti tying laws, and no existing industrial bank has been cited for a violation of that law.<sup>2</sup>

At the hearing, questions were asked about whether the best way to address concerns about tying bank and affiliates' products and services would be to prevent the affiliations in the first place. I do not agree. Had this rationale been employed in 1999, Congress would never have repealed the Glass-Steagall restriction against affiliations of banks and securities and insurance firms. Those affiliations are mostly driven by customer demand. Congress recognized that strong anti-tying laws can achieve the needed result without having to prohibit affiliations altogether. The record strongly supports that conclusion.

*Q.3. In 1987, during your time as the Utah Commissioner of Financial Institutions, you began what ended up as a ten year moratorium on new ILCs in Utah. Can you describe for the Committee the circumstances which led to that decision?*

This has been a subject of much misinformation and I appreciate the opportunity to clarify what actually happened.

Prior to 1987, most ILCs in Utah were organized by bank holding companies to take deposits from bank customers who demanded a market rate of interest when

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<sup>2</sup> Of course, credit is available at many retailers with incentives for using that credit to make purchases at the store. In those cases, the credit is either offered directly by the retailer and not through a subsidiary bank or the credit is offered by an unaffiliated bank working in partnership with the retailer. The anti tying laws and the affiliate transaction laws (23A and 23B) do not apply because the credit is either not originated by a bank or the bank is not an affiliate. For example, in house credit has been available at Home Depot stores for several years but the actual lender is an independent bank. For many years that bank was a subsidiary of General Electric. Recently it was replaced by a bank owned by Citigroup.

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federal law limited the interest rate an FDIC insured bank could pay. Those ILCs were privately insured. Some independent ILCs were also organized during that period. The ILCs did well until the federal limits on deposit rates were repealed in 1980. The ILCs found it difficult to compete directly with federally insured banks without the ability to offer higher interest on deposits. When the federal interest rate limits were repealed, the ILCs owned by bank holding companies were closed and merged into their bank affiliates. The remaining privately insured ILCs converted to FDIC insured banks if they could. Those that could not were sold or closed and liquidated. The losses from seven closed institutions exceeded the private insurance fund's reserves and the state had to provide assistance to cover those deposits. (Note: the failure rate of privately insured ILCs was about the same as for FDIC insured banks and NCUSIF insured credit unions and much lower than the failure rate for savings and loans insured by the FSLIC during the same period. No federally insured ILCs have failed in Utah).

In about 1987 the Utah legislature terminated the authority to issue new ILC charters. At that time it appeared that the industry was no longer viable. All of the privately insured companies had closed or converted to FDIC insured banks and it seemed unlikely that any new ILCs would be organized.

After the law terminating the authority to issue new ILC charters went into effect many out of state companies began expressing interest in acquiring ILC charters to expand into Utah from another state or to organize a new bank. At that time, operating banks across state lines was restricted but there were no limits on an out of state bank holding company owning and operating an ILC.<sup>3</sup> Although new charters could not be issued, it was determined that the charters of the failed ILCs could be sold. The money paid for those charters was used to help pay the depositors of the closed institutions. The first buyer of an ILC charter was a savings and loan based in Arizona that wanted to operate supermarket branches in Utah. It paid \$20,000 for the charter. The last charter sold was purchased by a major credit card issuer in 1996 for a much higher sum.

The termination of authority to issue new charters did not inhibit the development of the industrial banks between 1987 and 1996. It merely required a new bank organizer to buy an ILC charter issued prior to 1987. These were mostly purchases of a bare charter and required a de novo application for federal deposit insurance and an application to the state for approval of a de novo business plan for the new bank. The initial purchasers were some of the strongest and most prominent

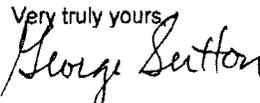
<sup>3</sup> The first Utah ILC owned by an out of state bank holding company was organized in 1980 and operated for about six years. That ILC was closed when the parent was able to acquire a failed commercial bank in the state and use that to establish full service bank operations.

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financial services companies in the nation including Merrill Lynch, American Express, Fidelity Investments, Dean Witter (now Morgan Stanley), USAA, General Electric and AT&T. The supply of pre 1987 charters was sufficient to support the development of approximately 15 banks during the ten year period when new ILC charters could not be issued. This included the sale of charters still held by the bank holding companies that had privately insured ILC subsidiaries prior to 1980 and some other inactive charters in addition to those held by the seven failed institutions. During the period from 1987 to 1996, the industrial bank industry developed into a successful and thriving group of banks that was drawing increasing interest across the nation. In 1996, when all of the pre 1987 charters were sold, the Utah legislature restored the authority to issue new charters to support the continuing development of the industry.

I hope this clarifies my statement during the Committee hearing and fully responds to your questions.

Very truly yours,  
  
George Sutton

cc: Rep. Spencer Bachus  
Rep. Barney Frank  
Rep. Jim Matheson  
Securities Industry Association

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