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H.R. 698, THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

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CONTENTS

	Page
Hearing held on:	
April 25, 2007	1
Appendix:	
April 25, 2007	51

WITNESSES

WEDNESDAY, APRIL 25, 2007

Bair, Hon. Sheila C., Chairman, Federal Deposit Insurance Corporation	9
Colby, Robert, Deputy Director, Market Regulation, Securities and Exchange Commission	14
Connelly, Arthur R., Chairman and Chief Executive Officer, South Shore Bancorp MHC, on behalf of America's Community Bankers	37
Douglas, John L., Alston & Bird LLP, on behalf of the American Financial Services Association	41
Ghiglieri, James P., Jr., President, Alpha Community Bank, on behalf of the Independent Community Bankers of America	38
Isaacs, Amy, National Director, Americans for Democratic Action	35
Kohn, Donald L., Vice Chairman, Board of Governors of the Federal Reserve System	12
Lackritz, Marc E., Chief Executive Officer, Securities Industry and Financial Markets Association	43
Leary, G. Edward, Commissioner, Department of Financial Institutions, State of Utah	17
McVicker, Earl D., Chairman and Chief Executive Officer, Central Bank & Trust Company, on behalf of the American Bankers Association	40
Reich, Hon. John M., Director, Office of Thrift Supervision	13
Stevens, Thomas M., Immediate Past President of the National Association of Realtors	45

APPENDIX

Prepared statements:	
Bair, Hon. Sheila C.	52
Colby, Robert	71
Connelly, Arthur R.	82
Douglas, John L.	87
Ghiglieri, James P., Jr.	95
Isaacs, Amy	113
Kohn, Donald L.	121
Lackritz, Marc E.	138
Leary, G. Edward	149
McVicker, Earl D.	172
Reich, Hon. John M.	183
Stevens, Thomas M.	200

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Gillmor, Hon. Paul E.:	
Letter from the American Bankers Association	210
Letter from America's Community Bankers	211
Letter from Independent Community Bankers of America	212
Letter from the National Association of Realtors	214
Letter from the Sound Banking Coalition	215

Page

Gillmor, Hon. Paul E.—Continued
Statement of Thomas J. Bliley, Jr., on behalf of the Sound Banking Coalition 217

H.R. 698, THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

Wednesday, April 25, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Watt, Sherman, Meeks, Moore of Kansas, Baca, Scott, Green, Cleaver, Davis of Tennessee, Sires, Ellison, Klein, Wilson, Perlmutter, Donnelly, Marshall; Bachus, Castle, Royce, Gillmor, Manzullo, Feeney, Hensarling, Brown-Waite, Barrett, Pearce, Neugebauer, and Bachmann.

Also present: Representative Matheson.

The CHAIRMAN. The hearing will come to order. The Committee on Financial Services meets today to consider legislation dealing with the Industrial Bank Holding Company Act, which was filed by myself and the ranking minority member of the Committee on Financial Services, the gentleman from Ohio, Mr. Gillmor. It deals with the question of whether or not the entity known as the Industrial Loan Corporation ought to be expanded or maintained at its current level.

I begin by saying that there's been a debate about the ILCs. It does seem to me that those who profess to be strong supporters of the Industrial Loan Corporation form ought to be the ones initiating legislation. That is, if you genuinely believe that the ILCs are an important financial institution, how does anyone justify limiting them so that only six States can charter them? I know of no other generally approved entity which can only be chartered by six States.

So I understand people who think ILCs are a wonderful thing and would therefore like to have them freely chartered. I understand those of us who think that we should restrict them. It is hard for me to understand a rational argument for the status quo in which we have this entity that exists in only a few States. Why would anyone do that?

Let me put it this way. It is inconceivable to me that anyone starting from scratch in a situation would say, "Okay, here's a nice institution we ought to have; we're going to call it an industrial loan corporation, and let's pick six States that are allowed to charter it." I don't know how you would pick the six States. I assume a dartboard would be an essential part of that decisionmaking

process. In other words we have what is the result of a historical accident, and it seems that we go one way or the other.

There are also people who argue that we have had the ILCs for this considerable period and there has not been any problem. Well, those of us who support this legislation generally agree with that because we are trying to preserve the status quo. Nothing that is being proposed would undo the current situation with regard to ILCs that exist.

Indeed, we had previously been told by the State of Utah where they are important, and I note the presence of our colleague from Utah, a former member of this committee, whose disagreement with us was sufficiently strong to cause him to return. And he has been a very able advocate of the interests of his State. But I do note that the last information we had was that over 90 percent of the ILC assets in the State of Utah would be unaffected by our legislation because they would meet the test of 85 percent financial.

But I do return to the point that we have an anomaly. I can understand going forward, I can understand going backward, but I do not see how anyone public policy can justify staying where we are.

Now what we find is—and people said, "Why are you dealing with this now if they haven't caused problems?" But what we are confronted with is people who have decided to significantly expand this entity, including major commercial organizations.

Again, I understand the argument from those who say that the distinction between commercial and banking activities is an artificial one, that it should fall. But if you believe that, then where's the language to repeal the restriction? Again, why this halfway, to put it in a way that will meet the rules of propriety, approach to a situation? What again is the justification for maintaining the general principle of a separation between banking and commerce and allowing this one narrow exception?

We, I hope, will go forward. We are trying again not to disturb the status quo. We have had some conversations with a kind of a border area involving securities, border in the sense, these are financial institutions and we will be—we have been working and having conversations and I want to thank—Chairwoman Bair is here and she has, on this as in so many other issues, been extremely helpful.

We are trying to work out the various regulatory approaches that should go forward. I do want to say that this has been one of the rare occasions in my memory when the Federal Reserve has been very flexible, and I hope that this is a pattern that we will see going forward.

But I think we have a very reasonable approach in the legislation. Obviously we are prepared to listen. And with that, I will recognize the ranking member.

Mr. BACHUS. I thank Chairman Frank for holding this hearing on H.R. 698, which is the Industrial Bank Holding Company Act of 2007. This legislation would enhance regulatory supervision of our ILCs, grandfather existing ILCs, and at the same time, prohibit commercial firms in the future from acquiring ILC charters.

At the outset, I want to commend the chairman and the gentleman from Ohio, Mr. Gillmor, who both worked tirelessly over the past several years to craft legislation on this complex issue.

Today's hearing will hopefully help us to better understand ILCs and the regulatory framework that surrounds the ILC charter. As ILCs have grown in size, number, and complexity, several supervisory and policy questions have arisen, including whether current regulatory structure for overseeing ILCs is adequate.

Insured ILCs are subject to State banking supervision and FDIC oversight as State, non-member banks. Nonetheless, owners of ILCs do not have to be bank holding companies subject to the Federal Reserve's consolidated supervisory authority.

In the absence of Federal Reserve's supervision of ILC holding companies, 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. Some have suggested that this regulatory regime does not provide sufficient protection against the potential risk that parent companies and non-banking affiliates may pose to the safety and soundness of ILCs.

Another matter of concern about ILCs is the extent to which they can mix banking and commerce through the holding company structure. An 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.

Certainly 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 ILCs when other similarly situated commercial entities already own them.

Once again, I want to thank Chairman Frank and Ranking Member Gillmor for their work on this important issue, and look forward to hearing from our witnesses today on their views on the legislation before us.

The CHAIRMAN. I will now recognize for 5 minutes one of our members who has been most active in this, the gentleman from Georgia, Mr. Marshall. And I will exercise my option to go to 15 minutes. The gentleman from Alabama may, if he wishes to, as well. So Mr. Marshall is recognized for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman. I don't believe I'll need 5 minutes. I appreciate the Chair recognizing me, and giving me an opportunity to say a few words on this particular subject.

It's kind of interesting. The first major problem we had in this country with mixing business and commerce resulted in legislation back in 1838 in New York and Georgia. Georgia actually took the lead in 1838 in forcing the separation of banking and commerce.

We've had other instances during our Nation's history where we inadvisably mixed the two. I shudder to think what kind of consequences we might have had had we not had those kinds of rules and we saw the collapses of entities like WorldCom, Enron, etc.

It just seems to me that we are in a very poor position to understand all of the complexities of the typical business operation in today's world and appreciate fully the risks associated with mixing those complex business operations with banking. It's tough enough for us just to regulate our banks without mixing—attempting to ad-

ditionally understand all the complexities associated with some of our current financial operations.

That said, clearly we have to grandfather, and it seems to me that the grandfathering provisions we should consider wouldn't simply stop at those ILCs that have been authorized thus far, but might consider those ILC applications that have been submitted in reliance upon the performance of the board with regard to granting ILCs because there are a number of entities that have legitimately gone out and relied upon the expectation that their ILC application will be approved, to their detriment if in fact this legislation is successful, and the cutoff is actually acquiring an ILC before the legislation is approved.

I do think that no further ILCs should be approved pending our consideration of this legislation. And then I'll simply add that there's a parallel here, it seems to me, between this issue and the question of whether or not banks should own real estate companies and other ventures that banks are sometimes interested in.

It seems to me that the banking industry, which is interested in not having commerce compete with banks through ILCs, should acknowledge that in fact banks should not be competing with commerce through business ventures like real estate, etc.

And I think perhaps, Mr. Chairman, if the chairman will move in that direction, it's something that we ought to consider. I appreciate the opportunity to say a few words, and I yield back, Mr. Chairman.

The CHAIRMAN. I now am pleased to recognize the coauthor of this bill, the ranking Republican on the Financial Institutions and Consumer Credit Subcommittee, the gentleman from Ohio, Mr. Gillmor, for 5 minutes.

Mr. GILLMOR. Thank you very much, Mr. Chairman, and let me also say that I have appreciated the opportunity over the past three Congresses to work with you on this issue.

We have been successful in the House; our amendment has passed two Congresses in a row. It didn't make it through the Senate, but I think that probably the third time is the charm, and I think we may get a different result in the Senate this time and get legislation to the President's desk.

I also want to commend Chairman Bair and the rest of the FDIC Board for their work on this issue. I want to thank all of our bank regulators for recognizing that the issue of the future of ILCs is a question that Congress should address. It is good and effective regulation that's the first line of defense in protecting the safety and soundness of our financial systems.

The principle here is real simple; it's the separation of banking and commerce. And financial systems which have not followed that principle have had a number of problems and, in fact, have had a number of crises because of it.

The United States codified this principle after the problems in the 1920's and the Great Depression. Over the last several decades, loopholes and exemptions in bank law have gradually been closed. In 1999, during consideration of Gramm-Leach-Bliley, Congress eliminated the unitary thrift loophole, and now it's time to close the ILC exception, which allows for full service banking by commercial firms.

This is a kind of historical accident, and frankly it wasn't much of a problem when there were only a few out there in existence, but what has happened is that a number of commercial and industrial firms have discovered this loophole, are applying for charters, and are going to try to drive a train right through the loophole unless Congress acts responsibly to close that loophole.

The bill that we've introduced, H.R. 698, would bolster the authority of the FDIC, limit the business activities of certain ILCs already in existence, and most importantly establish a cutoff date for new, commercially owned ILCs. Today we have approximately 120 cosponsors on the bill, and it's my hope that this bipartisan legislation will receive consideration in the committee in the near future and on the House Floor shortly thereafter.

And Mr. Chairman, I would ask that the following materials be submitted for the record: H.R. 698 support letters written by the Realtors, by the ICBA, by ACB, and by the ABA. Also, submitted testimony by former Congressman Tom Bliley on behalf of the Sound Banking Coalition, and a letter of support from the Coalition. And I would also ask unanimous consent to enter into the record a March 2007 GAO report which details suggestions for collaboration among the consolidated regulators.

[The GAO report referenced above (GAO–07–154) is available from the Government Accountability Office—www.gao.gov.]

The CHAIRMAN. Without objection, it is so ordered.

And now, on the unanimous consent—because I mentioned before, we've been joined here at the podium by a former colleague, our colleague from Utah, and he does represent a State where these are very important, so I would ask unanimous consent that the gentleman from Utah be allowed to participate in the hearing today.

I thank the ranking member. It is important that we get the diversity of views.

I will now recognize the chairwoman of the Financial Institutions and Consumer Credit Subcommittee, but I also want to explain. In about 5 minutes, I will be going around the corner to testify on the issue of fishing safety. The City of New Bedford, which I represent, is the leading fishing port in the country and we've had some safety issues. So I will be abstaining myself for a few minutes, but I will be back. We do appreciate—and I mentioned some of the regulators, Mr. Reich, it is very helpful to us to have had the cooperation of all the regulators in this as we have worked together on this operation, and we appreciate that, and the SEC as well.

The gentlewoman from New York is now recognized for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman. I appreciate your holding this hearing to discuss a bill that you and Mr. Gillmor have worked so hard on, and I join Mr. Gillmor in hoping that the third time is a charm. As he mentioned, there is a strong cross-section of support for this bill.

And in the bill, this committee has struggled to balance the need for the financial services that ILCs can provide with the primary imperative to preserve the safety and soundness of the banking system. This bill, in my view, has largely succeeded in doing that.

I am particularly sensitive to this issue since the savings and loan crisis, the bailout of the savings and loans crisis, was really the first issue that I voted on when I came to Congress, so I am keenly attuned to safety and soundness issues, and I hope we won't confront that again.

For the past year, the debate over ILCs has been largely shaped by the application of big commercial concerns and major auto companies—their push to own ILCs. Many members felt that these large companies were exploiting a loophole in Federal banking laws to merge commerce and banking, a combination that traditionally has been tightly restricted in the United States.

Last year, the Government Accountability Office issued a report specifically addressing these type of applications, saying that allowing commercial firms to own ILCs would "pose unnecessary risk," to the Federal Government's deposit insurance funds. Though the FDIC does have authority over insured ILCs, the GAO concluded that the fact that this authority does not explicitly extend to ILC holding companies, and therefore is less extensive than the authority that the consolidated supervisors have over banks and thrift holding companies, means that from a regulatory standpoint these ILCs, in their opinion, pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company.

In the wake of the GAO report, the Federal Reserve, including former Federal Reserve System Chairman Alan Greenspan and current Chairman Ben Bernanke, call for changes that would extend the regulations that apply to banks and bank holding companies to the ILCs and the companies that own them.

The need for new legislation arises in large part because of the change in the ILC industry over the past 20 years. ILCs were created in 1910 as limited purpose institutions to allow workers for big companies to get credit when they couldn't otherwise get loans. But according to the GAO report, ILC assets grew more than 3,900 percent between 1987 and 2006 to more than $155 billion, up from $3.8 billion.

ILCs also changed their character from small, community-based entities to large, company-based ones. From 1987 to 2006, the number of ILCs actually declined 42 percent, dropping to 61 from 106. As of March 2006, 9 of the country's ILCs were among the 271 financial institutions in the United States that hold more than $3 billion in assets. Six ILCs own more than 80 percent of the assets in the ILC industry with more than $125 billion in assets and $68 billion in FDIC-insured deposits.

Large ILCs divide between those that are owned by financial companies, subject to functional regulation by the SEC, such as Merrill and Morgan Stanley, and those that are owned by commercial firms, such as Target and GE. The bill very sensibly treats them differently and includes limits on activities to non-grandfathered entities to make sure that this distinction is preserved. I support this distinction but only to the extent that it is squared off soundly with safety and soundness, which is first on the agenda for this committee.

I look forward to the testimony. I see that Sheila Bair is back before us again; we have kept her very busy in this Congress. I look forward to all of the testimony. Thank you.

Mr. SCOTT. [presiding] Thank you. The gentleman from California, Mr. Royce, is recognized for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. Thank you very much for holding this hearing as well, and I want to thank our witnesses today for their testimony.

It has been mentioned that ILCs have been in existence in this country for, oh, I guess, about a hundred years. And it's very, very recently, I think, that the charter has garnered a great deal of attention. I encourage an open and honest debate on this, but I believe some of the criticisms of ILCs are misguided.

The amount of regulatory authority over the relationship between the ILC and their parent company continues to be a point of criticism for those who are opposed to the existence of ILCs, and some have expressed concern that an ILC might be used to subsidize a parent's cost to capital. Others have suggested that the ILC regulatory structure, in their view, is deficient because some ILC parents are not subject to supervision at the holding company level.

Well, just the beginning point I'd like to lay out is that industrial loan companies are regulated in a similar manner to all other federally insured depository institutions. They are subject to the same minimum capital standards, and subject to the same prompt corrective action provisions as every other bank we oversee in this committee. They must adhere to sections 23A and 23B of the Federal Reserve Act, just as all other FDIC-insured depository institutions do.

And as you know, these two provisions in the Federal Reserve Act subject all ILCs to very strict rules when it comes to relationships with any of their affiliates. Just to go down the rules very quickly: an ILC's total covered transactions with any affiliate cannot exceed 10 percent of the bank's capital; the ILC's total covered transaction with all affiliates combined cannot exceed 20 percent of the bank's capital; and with few limited exceptions, covered transactions must be fully secured with qualifying capital, and an ILC cannot purchase a low qualifying asset from an affiliate.

In addition, an ILC must deal with an affiliate on market or arm's length's term. It cannot, as a fiduciary, purchase securities or other assets from an affiliate unless permitted by statute or court order and the ILC cannot purchase securities while an affiliate is a principal underwriter for those securities. Neither the ILC nor its affiliate may purchase any advertisement or make any agreement stating or suggesting that the ILC shall in any way be liable for the obligations of the affiliate.

So that's the law. That's the current law. And in closing, the bill put forth today does nothing more than shield incumbent banking institutions, in my view, from competition. While I welcome the discussion on the fate of future industrial loan companies, I am concerned this bill could have some unintended consequences, which could have adverse impacts on the financial services industry and the economy as a whole. Industrial loan companies have proven their ability to create more competition in the industries,

resulting in better prices and services for consumers in this country.

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

Mr. SCOTT. Thank you. The gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much. Good morning ladies and gentlemen. I want to thank Chairman Frank and Ranking Member Bachus for holding today's hearing on H.R. 698, the Industrial Bank Holding Company Act of 2007.

Industrial loan companies, that is ILCs, state-chartered, FDIC-insured banks, were first established early in the 20th century to make small loans to industrial workers. Today's ILCs, which are supervised to some extent by the FDIC as well as by the chartering State, have grown dramatically in number and size and scope of activity. From 1997 to 2006, the assets held by Utah ILCs increased nearly 500 percent, from $25 billion to $150 billion, and the deposits held by Utah ILCs increased by more than 800 percent, from $11.9 billion to $107 billion.

A special exemption in current law, however, permits any type of company, including a commercial or retail firm to acquire an ILC in a handful of States, principally Utah, California, and Nevada, and to avoid the activity restrictions and supervisory requirements imposed on bank holding companies under the Federal Bank Holding Company Act.

ILCs were mostly small, local institutions that had limited deposit taking and lending powers until 1997 when Utah changed this law to permit Utah-chartered ILCs to call themselves banks and exercise the same powers as state-chartered commercial banks, resulting in the stampede of ILCs. Thus, Utah-chartered ILCs now may engage in any type of lending activity. The ILC charter is also a way for companies to avoid the activity restrictions and consolidated supervisory capital, managerial, and community reinvestment act requirements imposed on bank holding companies under the Bank Holding Act.

CRA has been an effective tool to require banks to make investments in low- and moderate-income communities. So should ILCs be subject to CRA? In 1997, the number of Utah ILCs had tripled and now there are more than 30 ILCs chartered in Utah, including a number that are owned by commercial companies such as General Electric, BMW, Pitney Bowes, and Sears. Home Depot is seeking to acquire an existing ILC.

The largest ILC at the time of the exemption adopted in 1987 had assets of less than $400 million. The largest ILC today has more than $62 billion in assets and $54 billion in deposits, making it the 12th largest insured bank in the United States by deposits.

Importantly, the ILC exemption does not limit the chartering of new ILCs. Utah and other States that are grandfathered by the exemption may continue to grant new ILC charters without limit.

Congress maintains the separation of banking and commerce and reaffirmed this policy in the Gramm-Leach-Bliley Act of 1999, when it closed the unitary thrift loophole and authorized banks to affiliate only with companies that are generally engaged in financial activities.

Congress determined in the GLB Act that with regard to financial affiliations, a bank holding company could only affiliate with a full service securities or insurance firm if the bank holding company held all its subsidiary depository institutions well-capitalized and well-managed in its subsidiary depository institutions, maintain at least a satisfactory CRA rating.

The ILC exception disadvantages bank holding companies and undermines these requirements by allowing some financial firms to operate federally insured ILCs without meeting these requirements. The parent companies of exempt ILCs are not subject to consolidated supervision under the Bank Holding Company Act. For this reason, the GAO concluded that ILCs may pose a greater risk to the deposit insurance funds than banks operating within the bank holding company structure.

Since 1956, consolidated supervision has been a fundamental component of bank supervision in the United States. It provides the board with both the ability to understand the financial strength and risk of the overall 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 bank in the Federal safety net.

The FDIC itself has acknowledged that it does not have the same supervisory, capital, and enforcement authority with respect to the holding companies of an ILC that the Board has with respect to bank holding companies. The ILC exemption also allows foreign banks to enter the banking business in the United States without meeting the requirements in the Bank Holding Company Act that the bank be subject to comprehensive consolidated supervision in its home country.

I believe this loophole must also be addressed. Therefore, I am pleased to hear from our witnesses today on ILCs, and I yield back the balance of my time.

Mr. SCOTT. Thank you, Ms. Waters. We'll get right to the witnesses. Just one point I wanted to mention, BMW and Target have ILCs and I think that brings up 2 questions that might be significant here this morning. Number one, how do we tell the average American why Ford and Home Depot should not be able to have what these other companies have? And number two, what studies have been done or what evidence or information do we have that BMW or Target are threatening to destroy our system of banking?

So with those questions, we'll get right to our witnesses. We'll start with Chairman Sheila Bair of the Federal Deposit Insurance Corporation. Thank you.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you very much. Members of the committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning Industrial Loan Companies. The FDIC strongly supports efforts to provide statutory guidance on the key issues regarding the ILC charter, especially the issue of commercial ownership.

Many of the issues surrounding ILC ownership involve important public policy considerations that are best left to Congress for reso-

lution. This hearing and congressional discussions regarding possible legislative solutions are encouraging developments that hopefully will lead to the resolution of key ILC-related issues by the end of the year.

ILCs have existed for almost 100 years, and for most of that time they operated similar to finance companies, providing loans to wage earners who could not otherwise obtain credit. ILCs have proven to be a strong, responsible part of our Nation's banking system and have offered innovative approaches to banking. Many have contributed significantly to community reinvestment and development. For example, a nonprofit community development corporation operates an ILC designed for the express purpose of serving the credit needs of people in east Los Angeles. Other ILCs serve customers who have not traditionally been served by other types of financial institutions such as providing credit for truck drivers to buy fuel far from home. The record to date demonstrates that the overall industry has operated in a safe and sound manner and that the FDIC has been a vigilant, responsible supervisor of that industry.

ILCs represent a very small part of the overall banking industry, composing less than 1 percent of the almost 8,700 insured depository institutions in this country, and only 1.8 percent of the assets. Of the 58 existing ILCs, 43 are either widely held or controlled by a parent company whose business is primarily financial in nature. These ILCs represent approximately 85 percent of ILC assets and 89 percent of ILC deposits. The remaining 15 ILCs are associated with parent companies that may be considered non-financial.

There has been significant growth in the ILC industry since the passage of CEBA in 1987 when the industry had $4.2 billion in assets. Over the years, total ILC industry assets have grown to $212.9 billion. Most of the growth has occurred since 1996 and has been concentrated in a small number of financial services firms.

In addition to the growth in the ILC industry, the character of ILCs has been changing. In the current business environment, many ILCs tend to be more complex and differ substantially from their original consumer lending focus. In many instances these ILCs serve a particular lending, funding, or processing function within a larger organization or directly support one or more affiliate's commercial activities.

Under this kind of ownership model, consolidated supervision may not be present and the current supervisory infrastructure may not provide sufficient safeguards to address safety and soundness issues and risks to the Deposit Insurance Fund.

To address these developing concerns, the FDIC has taken a number of actions regarding ILCs since this committee's last hearing on the topic. In July 2006, the FDIC Board of Directors adopted a 6-month moratorium on all applications for deposit insurance and change in control notices for ILCs.

During this pause in processing ILC applications, the FDIC sought public comment on 12 specific questions that focused on developments in the industry, the supervisory framework, and the issues surrounding commercial ownership. In response, the FDIC received more than 12,600 comment letters.

The 6-month moratorium allowed the FDIC to evaluate public and industry comments, assess developments in the industry, and consider how to best supply the Corporation's statutory powers for oversight of these charters. It is clear that the most significant concern regarding ILCs is their ownership by companies engaged in non-financial activities.

Based on the FDIC's analysis, the FDIC Board recently voted to extend the moratorium for an additional year. Under the extended moratorium, the FDIC will not take any action on any application for deposit insurance or any change in control notice for any ILC that would be controlled by a company primarily engaged in commercial activities.

Although commercially owned ILCs have not resulted in serious problems to date, the FDIC will continue to closely monitor existing ILCs that currently are controlled by commercial companies in light of the concerns that have been expressed.

The moratorium extension does not apply to ILCs that would be controlled by a company engaged only in financial activities or that would not be part of a holding company structure.

In addition to providing the FDIC with time to examine the appropriate supervisory structure for the changing ILC industry, extending the moratorium provides additional time for Congress to consider legislation. Although the FDIC is not endorsing any particular legislative approach, H.R. 698 does provide a workable framework for the supervision of ILC holding companies.

In closing, ILCs have a good safety and soundness record to date and have proven to be a strong, responsible part of our Nation's banking system. Yet the types and number of ILC applications have evolved in recent years and these changes do pose potential risks that deserve further study and raise important public policy issues.

The FDIC has a responsibility to consider applications under existing statutory criteria and make decisions. While it is appropriate to proceed cautiously, the FDIC cannot defer action on these matters indefinitely.

The current statutory exemption providing for the ILC charter is quite broad. By providing clear parameters to the scope of the charter, Congress can eliminate much of the uncertainty and controversy surrounding it. Resolving these issues will enhance the value of the ILC charter going forward.

The FDIC looks forward to working with Congress in the coming months as you work to bring these matters to closure. This concludes my statements, and I will be happy to answer any questions the committee might have.

Thank you, Mr. Chairman.

[The prepared statement of Chairman Bair can be found on page 52 of the appendix.]

Mr. SCOTT. Thank you. Thank you very much. Now we'll hear from Mr. Donald Kohn, Vice Chairman of the Board of Governors of the Federal Reserve System.

STATEMENT OF DONALD L. KOHN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you. I am pleased to be here today to provide the Federal Reserve Board's views on Industrial Loan Companies and H.R. 698. The Board commends the committee for considering the important public policy issues raised by the special exemption for ILCs.

ILCs are state-chartered and federally insured banks that have virtually all the powers and privileges of other insured banks. They operate under a special exception to the Federal Bank Holding Company Act that allows any type of company to acquire an ILC and avoid the restrictions Congress has established to separate banking and commerce. The exception also creates a special safety and soundness risk by allowing a company or foreign bank that is not subject to supervision on a consolidated or group-wide basis to acquire an insured bank.

By its nature, the exception creates an unlevel playing field that gives a growing number of firms a competitive edge over other community-based, regional, or diversified organizations that own an insured bank. When the special exception was adopted in 1987, most ILCs were small, locally owned institutions with limited powers. The size and activities of ILCs, however, have expanded significantly in recent years. Today many are controlled by large, internationally active firms.

Importantly, there is no limit on the number of ILCs that a handful of grandfathered States may charter or on the size that these institutions may attain. If left unchecked, the growth of ILCs threatens to undermine the policies that Congress has established governing the separation of banking and commerce and the proper supervisory framework for companies that own a federally insured bank.

That is why we believe congressional action is needed. Only Congress can address the full range of issues created by the ILC exception in a comprehensive and equitable manner. H.R. 698 takes an important step by granting the FDIC new consolidated supervisory authority for the corporate owners of ILCs that are not already supervised by a Federal agency.

H.R. 698, however, would not fully address the other important regulatory and competitive issues raised by the exception. For example, the bill would allow additional firms to acquire an ILC and derive up to 15 percent of their revenues from commercial activities.

This commercial basket is sizeable and at odds with the decisions made by Congress in the Gramm-Leach-Bliley Act to maintain the separation of banking and commerce. The Board believes that Congress should consider carefully the costs and benefits of changing the Nation's policies concerning the mixing of banking and commerce in a comprehensive way rather than to allow this policy to be eroded through the exploitation of a loophole.

H.R. 698, as introduced, also would allow the owners of ILCs to avoid the CRA, capital, and managerial requirements that apply to financial holding companies, and it would allow foreign banks that are not subject to consolidated supervision in their home country to acquire an FDIC-insured ILC.

These advantages granted, ILC owners would perpetuate competitive imbalances, provide incentives for firms to continue to exploit the exception, and undermine the prudential framework established for all other domestic and foreign firms that own an insured bank. The Board believes the best way to address these issues is to close the ILC loophole going forward. This approach recognizes the simple fact that ILCs are insured banks. It would prohibit additional firms engaged in commercial activities from acquiring ILCs, and would require that any new financial owner of an ILC operate under the same activity restrictions and regulatory framework that apply to bank holding companies.

For reasons of fairness, the Board also supports grandfathering those firms that currently own an ILC, subject to appropriate restrictions. This mirrors the approach that Congress took in 1970, 1987, and 1999, when earlier banking loopholes were used in unintended and potentially damaging ways.

Thank you for the opportunity to testify on behalf of the Board. We would be pleased to continue to work with the committee in developing and improving legislation that addresses the very important public policy issues raised by the ILC exception.

[The prepared statement of Mr. Kohn can be found on page 121 of the appendix.]

Mr. SCOTT. Thank you very much, Mr. Kohn. Now we will hear from the Hon. John Reich, who is the Director of the Office of Thrift Supervision.

STATEMENT OF THE HONORABLE JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Thank you. Good morning, Mr. Chairman, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to testify on H.R. 698, introduced by Chairman Frank and Mr. Gillmor to address the activities, ownership, and control of Industrial Loan Companies. I applaud your leadership and the work of other members of the committee who cosponsored this legislation.

H.R. 698 addresses several pending policy issues with respect to the key areas of the permissible activities and oversight of companies that own or control or seek to acquire or control an ILC. For our part, at the Office of Thrift Supervision, we appreciate the recognition in H.R. 698 of the important and continuing role that the OTS has in our oversight and supervision of several of the largest companies that currently own and control ILCs.

OTS has statutory authority for the consolidated supervision of General Electric, Merrill Lynch, Morgan Stanley, Lehman Brothers, American Express, USAA, Bell Financial, and General Motors. The eight ILCs within these OTS-regulated savings and loan holding company structures control about two-thirds of the ILC assets in the country as of December 31, 2006.

Functional regulation and consolidated regulatory oversight have been important considerations by the committee. H.R. 698 maintains a clear focus on the enterprise-wide safety and soundness of holding companies that own or control institutions with access to the Federal safety net.

The bill also is sensitive to the potential exposure of the Federal safety net by a company that owns or controls an ILC by focusing on the interrelationships within an ILC holding company and how the ILC is integrated within the structure. Effective oversight of holding companies requires adequate regulatory controls to monitor and intervene when necessary without unduly interfering with the ongoing business operation and activities of an enterprise. It's a balance, requiring judgement based on expertise in a wide range of areas.

As detailed in my written statement, the OTS focuses and tailors its holding company supervision based on the complexity of the structure and the level of risk inherent in the holding company enterprise. Comprehensive holding company supervision is a combination of ongoing offsite monitoring, targeted reviews of key businesses or functions, and regular onsite examinations.

This approach permits OTS to understand the business and its inherent risks as well as the affiliations and the transactions of the enterprise. It also enables us to assess the potential impact of the broader economy, the insured depository institution, and the potential exposure to the Federal safety net.

As currently drafted, H.R. 698 preserves OTS's statutory oversight of savings and loan holding companies that own or control ILCs, promotes functional regulation while promoting consolidated regulatory oversight and it maintains a risk-based focus on companies owning or controlling institutions with access to the Federal safety net. For these reasons, we support H.R. 698 as introduced by Chairman Frank, Congressman Gillmor, and other sponsors on the committee.

Thank you, and I'll be happy to take questions.

[The prepared statement of Director Reich can be found on page 183 of the appendix.]

The CHAIRMAN. Thank you, and next we have Mr. Robert Colby, who is the Deputy Director of the Division of Market Regulation of the SEC. Mr. Colby, thank you. Please go ahead.

STATEMENT OF ROBERT COLBY, DEPUTY DIRECTOR, MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Mr. COLBY. Thank you. I'm very pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for supervising U.S. securities firms on a consolidated basis and how this provides protection to all regulated entities in the consolidated group including industrial loan companies that are the topic of this morning's hearing.

And I appreciate the discussions we've had with Chairman Frank and his staff about possible amendments to H.R. 698 that would avoid subjecting U.S. securities firms already supervised by the Commission under comprehensive and effective program to a second and duplicative consolidated supervision regime.

The Commission currently supervises five of the major U.S. securities firms on a consolidated or group-wide basis. For such firms, referred to as Consolidated Supervised Entities, or CSEs, the Commission oversees not only the U.S.-registered broker dealer, but also the holding company and all affiliates on a consolidated basis. These affiliates also include other regulated entities such as foreign

registered broker dealers and banks as well as unregulated entities such as derivatives dealers.

Four of the CSEs, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley own ILCs that account for 1.1-, .7-, 7.2-, and 1.2 percent of their consolidated assets respectively. Three of the firms, Lehman Brothers, Merrill Lynch, and Morgan Stanley also own thrifts that account for 3.8-, 1.7-, and less than one one-hundredth of one percent of their consolidated assets respectively.

The CSE program provides consolidated supervision to investment bank holding companies that's designed to be broadly consistent with the Federal Reserve oversight of bank holding companies. This prudential program is crafted to allow the Commission to monitor for and act quickly in response to financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including U.S. and foreign registered investment banks and broker dealers or the broader financial system at risk.

When a CSE firm has a regulated entity in the consolidated group that is subject to oversight by another functional regulator, the Commission defers to that functional regulator as the supervisor of the regulated affiliate. We also share relevant information concerning the holding company with our fellow regulators both domestically and internationally. The Commission's CSE program has been recognized as equivalent to that of other internationally recognized supervisors, including the U.S. Federal Reserve, for purposes of the European Union's Financial Conglomerate Directive.

While maintaining broad consistency with the Federal Reserve holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE program reflects the reliance of securities firms on market-to-market accounting as a critical risk and governance control. Second, the design of the CSE program reflects the critical importance of maintaining adequate liquidity in all market environments for holding companies that do not have access to the external liquidity provider.

The Commission's concern regarding the need for group-wide risk monitoring, which developed over the course of a number of years beginning with the Drexel Burnham liquidation in 1990, was paralleled by the European Union's Financial Conglomerate Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis.

In response, in 2004, the Commission crafted a new, comprehensive consolidated supervision program that was intended to protect all regulated entities within a group, including broker-dealers. The rule restricted CSE eligibility to groups with large and well-capitalized broker-dealers. The Commission believed that it could only supervise on a consolidated basis those firms engaged primarily in securities business and not holding companies that are affiliated with the broker-dealer as an incident to their primary business activities. To this end, the rule effectively requires that the principal broker-dealer have a tentative net capital of at least $5 billion.

The CSE program has five principal components. First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission

at the time of initial application. Second, before approval, and on an ongoing basis, the Commission examines the implementation of these controls. Third, CSEs are monitored continuously for financial or operational weakness that might put at risk regulated entities within the group or the broader financial system. Fourth, CSEs are required to compute a capital adequacy measure at the holding company level that's consistent with the Basel standard. Finally, CSEs are required to maintain significant pools of liquidity at the holding company where these are available for use in any regulated or unregulated entity within the group without regulatory restriction.

I'd like to point out that these five principal components are implemented in conjunction with the authority to protect regulated entities within the groups. When potential weaknesses are identified, the Commission has broad discretion under our rules to respond. For example, the Commission could mandate changes to a firm's risk management policies and procedures, effectively require an increase in the amount of regulatory capital maintained at the holding company, or require an expansion of the pool of highly liquid assets held at the parent.

These powers are not theoretical abstractions. All three of these steps have been taken at various CSEs over the past 2 years.

This program of consolidated supervision reduces the likelihood that weakness within the holding company or an unregulated affiliate will place a regulated entity including the ILC or the broader financial system at risk. My written testimony describes in greater detail the means by which we monitor the financial operational condition of the holding company.

In conclusion, while we generally support the goals of H.R. 698, the bill as introduced would subject the CSEs that are already highly regulated under the Commission's consolidated supervised program to an additional level of duplicative and burdensome holding company oversight. We believe the bill should be amended to recognize the demonstrated ability of the Commission to comprehensively supervise the consolidated groups that are overwhelmingly in the securities business, especially given the heightened focus on these issues in an area of increased global competitiveness.

Because the Commission has established a successful consolidated supervision program based on its unique expertise in overseeing securities firms, the CSE should be carved out of this legislation in the same way as the holding companies supervised by the Federal Reserve and OTS.

Thank you again for the opportunity to speak on behalf of the Commission.

[The prepared statement of Mr. Colby can be found on page 71 of the appendix.]

The CHAIRMAN. Thank you, Mr. Colby. And finally I want to again welcome Commissioner Leary from the Department of Financial Institutions, State of Utah. He has been very accommodating in appearing before the committee and helping us in our deliberations. Commissioner, thank you, and please proceed.

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

Mr. LEARY. Good morning. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. Thank you for the opportunity to share Utah's view on H.R. 698, the Industrial Bank Holding Company Act of 2007.

I am Edward Leary, commissioner of financial institutions for the State of Utah. I have been involved with banking for 33 years, first as a community banker, then 15 years in various bank examiner positions with the Utah department and for the last 15 years as its commissioner.

The Utah Department of Financial Institutions views H.R. 698 as unnecessary and an effort to restrict and restrain state-chartered industrial banking without a valid safety and soundness concern or a crisis. Utah believes there is good supervision and good regulatory model over the industry without a question of the competency of the regulators in that there has not been an industrial bank failure warranting this change in public policy.

I believe that I am here today because of the success of that regulatory model, not its failure. Utah, in partnership with the FDIC, has built a regulatory model to which the financial services market has reacted favorably.

This regulatory model is not a system of lax regulation and supervision or inadequate enforcement. Utah industrial banks are safe, sound, and appropriately regulated by both the State which charters them, and the FDIC, which is the relevant Federal regulator and deposit insurance provider.

I am told the articulated threat which warrants passage of this bill is a potential threat of misuse of the charter by holding companies which are non-financially oriented. This bill seeks to remove a potential threat even before the threat has materialized or manifests itself.

We should be clear. We are talking about an industry today that constitutes 1.8 percent of banking assets. This is not a systemic crisis that threatens banking.

An analysis of the numbers as of December 31, 2006, developed by Utah, indicates that we hold 88 percent of all industrial bank assets. Based upon our knowledge of the holding companies, we estimate that 86 percent of Utah industrial bank assets would be considered held by financial entities, constituting 22 companies, and 14 percent by non-financial entities, constituting 9 companies.

Our analysis is that 7 of Utah's industrial banks, representing approximately 80 percent of our assets are subject to consolidated Federal agency supervision at the holding company level. The Federal agencies we considered are: one, the Federal Reserve, with jurisdiction over our 2nd largest bank; the OTS, with jurisdiction over our largest, 3rd, and 4th largest banks; and the SEC, with jurisdiction over our 6th largest bank.

The record of the last 18 months is that no de novo industrial bank charter was approved by the FDIC from November 4, 2005, until March 20, 2007. H.R. 698 will dismantle a Utah industrial banking industry of 31 charters and a regulatory structure that has matured over 20 years with a record of safe, sound operations to forestall one entity from being granted a charter.

This bill, with its provisions that are designed to block any and all conceivable ways in which a retailer may employ an industrial bank charter today or in the future are disappointingly anti-competitive and anti-consumer. The targeted large retailer withdrew its application with the application having never been accepted by the Utah department.

H.R. 698 provisions are being justified under the text of preserving the prohibition against the merging of banking and commerce. The broad brush strokes of this bill include as collateral damage large financial arms of entities which have been in the financial arena for decades, such as Daimler Chrysler and Ford.

The former submitted an application for an industrial bank charter in May of 2005, which was approved by my State a year ago. Now, under the provisions of this bill, we will not be allowed to proceed. This is a disappointing outcome when other auto lenders have a bank charter.

The supporters of 698 present the bill as a compromise piece of legislation. I am challenged to determine how this bill is a compromise when industrial banks do not receive additional powers or authorities or have any of the current restrictions lifted, let alone given the right to issue commercial mal accounts as has previously been passed by this committee.

As a State regulator, what is most disappointing to observe is that while this committee is aggressively moving H.R. 698, a bill which restricts and limits the one segment of state-chartered banking that could be identified as innovative and creative, Congress has not taken seriously the threat to State banking of the broad, Federal preemption of State laws by the Comptroller's office. Many State commissioners believe that without congressional intervention, the diminishing assets under State charter will eventually render the State banking system irrelevant.

In conclusion, the industrial banking industry represents 1.8 percent of total banking assets. This is not an industry which threatens the safety and soundness of banking. The regulatory model is not a parallel bank regulatory system in that 80 percent of Utah assets are subject to Federal agency oversight at the holding company level.

Thank you for allowing me the opportunity to express my thoughts and for your willingness to listen to a State regulator.

[The prepared statement of Mr. Leary can be found on page 149 of the appendix.]

The CHAIRMAN. I'm going to begin with that. Your suggestion that we don't pay attention to State regulators is really unfounded, and I vigorously disagree with your assertion that we are ignoring the implications for federalism of the preemption decision.

Many of us in this committee last year were quite active in opposing that. When party control changed, frankly, and some of us had the opportunity to do something about it, we held off because of the pendency of the Wachovia decision. And, frankly, contrary to the suggestion you made implicitly, I think it would have been irresponsible for us to have jumped in while the Wachovia decision was pending, because there was a real issue there. The Supreme Court voted 5 to 3, I think, if Justice Thomas hadn't recused, looking at the past, it would have been 5 to 4. Well, a 5 to 4 decision sug-

gested there was some real uncertainty. And, no, we couldn't act until we knew that.

Now many of us do plan to act, and the gentlewoman from New York and I have had several conversations about this. I don't know that we—I don't think, to be honest, that we're in a position to have the votes to overturn that. We do plan to ask the Comptroller and the Office of Thrift Supervision, who are the ones who now have preempted, to tell us what they plan to do with regard to enforcement. And that includes trying to restore, in my judgment, some State visitation rights. So I just want to clear up what I think is an erroneous suggestion that we have been indifferent to that. And as I said, we would have started on it quicker, but we waited for Wachovia. We have had these conversations.

Second, I just want to ask you, would you favor legislation that removed the restriction on the granting of ILC charters to only those six States that were grandfathered?

Mr. LEARY. I have been asked in numerous forums, Mr. Chairman, how I address that issue that only six, I believe the exemption granted in—

The CHAIRMAN. No, I just asked you—no, excuse me, Mr. Leary. Excuse me. History isn't the fact here. I'm asking you as a matter of public policy if you would support our removing that restriction and allowing every State to do it.

Mr. LEARY. I have no problem with that, provided that the safety and soundness and the—

The CHAIRMAN. Well, I have no problem with—are you in favor—would you support such a bill?

Mr. LEARY. I am.

The CHAIRMAN. What about the fundamental distinction between banking and commerce that's in Gramm-Leach-Bliley? Would you support that? I say that because some advocates of the ILC say really that's a mistake to have that, to maintain that restriction. Would you maintain it or abolish it?

Mr. LEARY. I went on record last time when I was in front of the subcommittee saying I do not favor repeal of the Bank Holding Company Act, no. I'm a lifelong regulator; I believe in slow, measured steps towards this system. I believe what Utah created is a safe and sound system. I am articulating, I hope—

The CHAIRMAN. So you would maintain the distinction between banking and commerce?

Mr. LEARY. I would work towards a system where this could be more competitive than it currently is.

The CHAIRMAN. I don't understand that. Would you maintain the distinction between banking and commerce?

Mr. LEARY. I do not believe that I would.

The CHAIRMAN. So you would do away with the distinction—you would do it more slowly than some others might. But you—

Mr. LEARY. I would do it, as I tried to say, in slow, measured steps.

The CHAIRMAN. Okay, and I think that puts it fairly. I think that's a defensible and actual position with which I disagree. I do not think it is a defensible and actual position to say that we should maintain the distinction between banking and commerce and allow six States to be exceptions from it. You haven't main-

tained that. Others have. And I do think it's—people ought to understand the implications of what we are doing.

Let me ask Chairwoman Bair, who has a major role in this, and whose administrative limbo we hope to—I notice that the Pope is thinking of doing away with the kind of ambiguous category. We should do at least the same for you.

[Laughter]

The CHAIRMAN. But one—look, the House is going to pass a bill that I believe is fairly restrictive. I also understand that the Senate is probably not going to pass a bill similar to ours. Indeed, there are days, of course, when one wonders whether the Senate will ever pass any bill at all on anything, but that's a broader set of questions.

If we were to go to a House-Senate conference in which something very much like the bill the gentleman from Ohio and I have sponsored had passed the House, and a bill had passed the Senate that allowed for some things. It's no secret. The commissioner mentioned, for instance, the Daimler Chrysler and Ford situations.

There is a GM thing, and we appreciate it, and as you know, when GM wanted to sell to Cerebus, we communicated that we thought that was a situation that could get resolved. It's not a secret that the Senate is probably going to do, I believe something, not quite as restrictive as—if the Senate were to pass legislation that allowed for some continuation but with some restriction—or let's put it this way. If you were given the authority, not that you asked for it, but if you were given the authority to grant sort of limited extensions, would you have the power now to enforce that? I guess that's the question. That if there is—there will be two questions.

Is there a hybrid of some sort? And the gentleman from Ohio and I want as little of that as possible. I'm not encouraging it or asking for it, but I recognize that it may happen. If it does, it does seem to me then the one critical question will be, what will be the enforcement, the capability of the FDIC to impose these restrictions and subsequently to enforce them? Would you address that?

Ms. BAIR. The Fed and FDIC both agree that the current exception is quite broad. So for us to come in and say, certain categories of commercial owners can have ILCs and certain categories cannot, I don't see how we can do that under the existing framework, which is again where we think legislation would be very helpful. We're not taking a position about where to draw the line, but we think clarification would be very helpful. So, once Congress clarifies what those parameters are, yes, we would have—or we could use our existing enforcement authority regarding the ILC. And assuming we were given holding company authorities, we would be able to supervise them.

The CHAIRMAN. And we would do that for all of the agencies. And I do want to say in closing, we appreciate the cooperation, frankly, that we've seen from all of the agencies here. And maybe you have—the fact that were all able to cooperate so well may to some extent alleviate the FSA envy that appears to have run through the American financial entities in which the lament the fact that there are so many of you and dream of having only one.

Since that dream is not going to come true, we are pleased that you were able to show them an ability to cooperate in this situation.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. My first question I'll just ask all the regulators is, I'll start with Chairman Bair maybe and work across. Have ILCs, including those owned by commercial firms, posed safety and soundness problems to a greater or lesser extent than those depository institutions owned by traditional bank holding companies?

Ms. BAIR. No. The safety and soundness record to date is very comparable to that of other types of depository institutions. That was acknowledged in the GAO report. I would also add that actually the commercially-owned ILCs have the better safety and soundness record. Among commercially-owned ILCs, as well as Utah-chartered ILCs, there has never been a failure.

Mr. BACHUS. Okay. Anybody?

Mr. KOHN. No, sir. I don't think that the ILCs to date have posed an unusual safety and soundness issue. But as all of us have pointed out in our testimony, we're really at the cusp of a change, a wave of change, in how the ILC charter has been used. Some of those changes are very recent, and therefore the amount of deposits and assets in ILCs have grown extraordinarily rapidly in the last few years. And if something isn't done, it'll grow even more rapidly in the future.

So, yes, this is about a potential problem.

Mr. BACHUS. Okay.

Mr. KOHN. And the potential problem is the inadequate supervision and regulation of the companies that own ILCs.

Mr. BACHUS. All right. There's a notion that if commercial companies own ILCs, the deposit insurance fund is at risk if the company encounters financial difficulties. Is that true? And I guess as the assets grow, it becomes—

Mr. KOHN. I think there's a history of problems spilling from one part of a holding company to another, even when—say, the insured entity in the holding company has been well-regulated. There are reputational risks. There are legal risks. Many of these ILCs and banks, for that matter, are managed on a very closely integrated basis with their affiliate companies.

The companies that manage depository institutions and holding companies don't really differentiate between the depository institution, many of them, and the other entities. The public is looking at the consolidated entity. Therefore, it doesn't really differentiate, and many of the depository institutions rely on the affiliates for many of the services they use.

So, I think there is a history of problems occurring outside the depository that impugn and reflect on the reputation of the depository itself. That's why Congress itself in 1957, 1970, 1987, and 1999 decided that consolidated regulation was the way to protect—

Mr. BACHUS. Okay. Let me—Mr. Leary, let me ask you. Has there ever been a case when an ILC owned by a commercial firm has had financial difficulty that affected the ILC?

Mr. LEARY. In our case, the two cases which you could cite, which would be Conseco and Tyco, both—one case, the ultimate

parent filed bankruptcy. In the second one, the parent had difficulties in both case. The industrial bank component within that entity in one case was sold off. In the other case, they spun it off in an IPO and actually incurred a premium from that.

So, I would not want to represent that it was not without lots of concerns, blood, sweat, and tears. It successfully passed the test, and those examples are in my testimony.

Mr. BACHUS. Okay.

Mr. LEARY. May I respond to your question on commercial entities?

Mr. BACHUS. Yes.

Mr. LEARY. Because I don't believe the lines are as solid as some would like to believe. Two of our nine nonfinancial entities, one of which is BMW, have already been cited. The other is Volkswagen. Both of those, while they are perceived in the United States as being commercial entities, have very large banking operations in Europe. So, I believe the line is not as strict as it is.

And if I can beg your indulgence one step further, one of the others, Transportation Alliance Bank, is the one cited, I believe by Chairman Bair in her testimony, which has specifically targeted long-haul truckers and the trucking industry, which they believe is underserved by existing financial services companies. And they have targeted that business line and tried to provide financial services to that industry.

Mr. BACHUS. You know, you're talking about BMW and Volkswagen, I guess, are both German companies—

Mr. LEARY. Correct.

Mr. BACHUS. So they have a strong banking regulator in their home country. But what if it were, say, they were headquartered in a country that didn't have a—where they weren't subject to consolidated supervision in their home country? Would that concern you?

Mr. LEARY. We would require them to establish U.S. operations. And before we'd even consider the applications, it would be strictly reviewed. I think as we looked at, for example, UBS, we relied on the FDIC to look at the home country supervisor and supervision at that level, but we also required strong measures and prudential standards when we chartered UBS Bank in Utah.

Mr. BACHUS. I know Mr. Kohn mentioned that 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 power. This gap in current law needs to be addressed. Would the two of you comment on that?

Mr. KOHN. I think my testimony speaks for itself, Mr. Bachus. Congress passed that requirement after BCCI, which was a case in which there were regulated entities in the United States but problems overseas in a vast network of unregulated entities or inadequately regulated entities, that ended up spilling over into and onto the U.S. entities.

So, just having a regulated entity in the United States, in Congress's view, and I agree with it, was not sufficient to protect.

Mr. BACHUS. Does this legislation set up such a protection, or would it still be—

Mr. KOHN. Not as currently submitted. It does not have the requirement for consolidated supervision of a foreign entity.

Mr. BACHUS. So a foreign bank in a country where it doesn't have consolidated supervision could obtain a—

Mr. KOHN. Could establish an ILC under the law, under the act as proposed, bill as proposed.

Mr. BACHUS. Okay. Thank you.

Mrs. MALONEY. [presiding] Thank you. The Chair recognizes herself for 5 minutes, and I raised the question with—the same question with Chairman Frank earlier, and he says that they are working with language that would require the consolidated supervision. So that is a positive step forward coming out of this hearing.

I heard in some of the testimony that the current regulatory structure of the ILCs creates an uneven playing field within the banking industry. Could you please explain this further and what we can do to level this playing field?

Ms. BAIR. Well, I think the argument is that ILCs chartered in the States specified in CEBA are exempt from Bank Holding Company Act regulation. I think that is at the core of the regulatory playing field argument.

It has also been argued, especially by community banks, that it doesn't work both ways. The commercial entities under the ILC exception can own banks, but banks can't do commercial activities, so I think those are the arguments.

Mrs. MALONEY. You outlined in your testimony, Ms. Bair, the regulatory tools for ILC parents being the same as for bank holding companies. If that was legislated into law, would that address this challenge?

Ms. BAIR. Yes. There are a variety of holding company regimes. The Fed obviously is the leading bank holding company regulator. The OTS has also long been involved in holding company supervision, and the SEC has recently crafted its own system of consolidated supervision, so you have a variety of different approaches.

We think, as my written testimony indicates, that we would like powers comparable to the Fed. If you're going to make us a holding company supervisor, we think all three are certainly very good supervisors, but the Fed's authorities under the Bank Holding Company Act would be most desirable.

Mr. KOHN. Congresswoman, may I comment?

Mrs. MALONEY. Surely.

Mr. KOHN. There's another aspect of the competitive inequality, and that's the mixing of banking and commerce. So even under the bill as proposed, the ILCs would be able to have 15 percent commerce activities, and that is not permitted to financial holding companies and bank holding companies.

So the supervision, the consolidated supervision, is an extremely important point, clearing up the foreign bank issue is an extremely important point, but it doesn't go all the way to leveling the playing field. And the way to level the playing field is to simply close the loophole and make insured ILCs subject to the same regulations every other insured bank is subject to.

Mrs. MALONEY. Under Gramm-Leach-Bliley, doesn't that allow a 15 percent—

Mr. KOHN. No, ma'am, it does not. In Gramm-Leach-Bliley, there was a transition provision such that a financial holding company that had commercial activities would have some time to get rid of those commercial activities, but it must divest itself of those commercial activities.

There is no commercial basket in Gramm-Leach-Bliley. And the Federal Reserve gives banks—or financial holding companies—2 years, which can be extended for a couple of years, up to 5 years, to divest themselves of all their commercial activities. There are no commercial activities, except as might be incidental to a financial activity, allowed in Gramm-Leach-Bliley. There is no 15 percent basket there.

Mrs. MALONEY. Would you elaborate further on the risks of mixing banking and commerce? You seem tremendously concerned about this. What are the conflicts of interest that arise between the bank and the commercial transactions of a business? Could you elaborate further why you feel this so-called loophole should be closed?

Mr. KOHN. I think mixing banking and commerce raises a number of very difficult issues that the Congress needs to consider thoroughly before allowing even a limited exception to this.

There is the potential for conflicts of interest. Is the bank making loans on more favorable terms to its affiliates—there are restrictions here—or to customers of its affiliates, than it would to a customer of an unaffiliated institution? If a commercial firm owns a bank, can competitors of that commercial firm have the same access to credit on the same terms as the commercial firm itself?

There are issues about the potential for spreading the safety net. Banks are special. They have deposit insurance. They have access to the discount window. Congress has recognized that this carries the risk that there will be a perception that they have specific protections. They have access to the safety net.

I think because, as I noted before, banks and their affiliates often operate on a very consolidated basis, there's a risk that when a commercial affiliate is connected with a bank, the perception will be that the authorities wouldn't let problems in that commercial affiliate sort of cascade into the bank, that the commercial affiliate would have a special access to the safety net.

And finally, as I think Mr. Marshall pointed out in his opening comments, I think the consolidated regulation that we're talking about imposing would be much more difficult if there is a commercial component to the holding company. Working with the SEC, the thrift regulators, and insurance regulators, I think we have a better handle on the safety and soundness of non-bank financial affiliates of banks.

I think this would be very, very difficult to really do effective consolidated regulation if there is a commercial affiliate of the regulated institution.

Mrs. MALONEY. Well, this is—just very briefly, could we just go down the line and see how people feel? Do they feel that this is—that the 15 percent commercial activity is a challenge? Ms. Bair?

Ms. BAIR. We think the 15 percent is workable. We're being agnostic about where you want to draw the line. I would say, again, in the past, there already has been some experimentation with

commercial ownership with the ILC charter to date. We have a good safety and soundness record to date. It certainly would also be within the prerogative of the committee to allow some limited mixing using this 15 percent criterion.

In our view, it's the committee's decision. It's a policy call to make.

Mrs. MALONEY. Okay.

Mr. REICH. I would agree with Chairman Bair. It certainly is the committee's policy call. I think there are other examples, particularly in the tax code, where 15 percent has been used sort of as a de minimis level of unrelated income.

Mr. COLBY. This is not an area of core expertise for the Commission. We really think it's an area for the Congress to decide.

Mrs. MALONEY. Okay. Commissioner?

Mr. LEARY. I would endorse it, yes. I believe what we have attempted to do in Utah is to very effectively work within this core threat of having a commercial parent and allowing a basket, whatever the committee establishes, I think we would be very comfortable with.

We are currently working with General Electric, that has an OTS bank and a Utah Industrial Bank, and I think we are working very carefully at ensuring that safety net does not extend to the whole GE operation, that we isolate that—those insured entities very carefully.

Mrs. MALONEY. Okay. My time has expired. Mr. Gillmor, the cosponsor of the legislation.

Mr. GILLMOR. Thank you, Madam Chairwoman. A couple of questions, Commissioner Leary. You stated a number of times that the legislation would restrict banks and would make State banking irrelevant.

I don't think that's an accurate description of the legislation. The legislation doesn't do anything to affect the operation of the bank. Nothing. The only thing the legislation deals with—well, I'll ask you. Maybe you could point out specifically what it does to restrict, because mainly what we're talking about is ownership at a holding company.

Mr. LEARY. I would answer it this way, sir. In our case, we've approved three charters that the FDIC, under its moratorium, has not been able to successfully approve. We would not have approved those charters if we did not believe they warrant the granting of the charter and warrant the granting of deposit insurance from the entities.

I believe that what we have developed is a safe and sound model.

Mr. GILLMOR. Well, I guess the other thing I'd like you to do, since other state-chartered banks and other banks are subject to these same rules, do you think those rules restrict them? I mean, why would it only restrict ILCs?

Mr. LEARY. I would probably take a tack that I've developed in my own logic trail over the years.

What I believe we're doing with a number of these companies is when they've been identified as commercial entity, I do not see it much differently than the majority of my community banks that are primarily owned by businesspeople in the community, whether it's the lumber operator, the gas station owner, or whatever. So,

they bring with them a specific commercial expertise and a commercial perspective. I think that's very similar to what we're doing with some of these companies.

Do we want to isolate that and provide safety and soundness mechanisms? I believe Regulation 23A and B does that, and for the ILCs, we religiously enforce that upon them. So, my answer is, I think there is conceptually, it's not far to go from businesspeople owning a community bank to an entity that is large that has a small component which is an insured bank.

I hope I've answered your question.

Mr. GILLMOR. I think we just have a different philosophy. For example, when you said that restricting commercial ownership of ILCs would be anticompetitive, do you think the Bank Holding Company Act is anticompetitive?

Mr. LEARY. No. But I think I've already gone on record as saying I think there are some areas that could be worked on. Do I endorse repealing? No.

Mr. GILLMOR. You don't endorse repealing that?

Mr. LEARY. I do not.

Mr. GILLMOR. But you don't want ILCs subject to comparable type of provisions?

Mr. LEARY. I think they are. Everybody keeps talking about the one side, but the ILCs are limited. They cannot have demand deposits if they exceed $100 million. I brought up in my remarks that at one point, the committee passed a bill that would allow commercial NOW accounts for ILCs, somewhat leveling the offerings that the industrial banks can offer to their customers.

So, I think it's a very delicate balance, but I do not have a problem with what we're doing here, provided it's safe, and provided it's sound.

Mr. GILLMOR. Okay. Thank you. Let me ask the SEC, because there's a possibility under this legislation that you're going to be a consolidated regulator. If you were given the power to regulate industrial bank parents, depending on what kind of parent it is, do you think the SEC would have to request additional powers to provide for safety and soundness, or are you equipped now to do that?

Mr. COLBY. I believe that the program that we're currently operating can take into account the needs of the ILC because the possibility that what happens in the holding company could affect the ILC, so I don't think you'd need more safety and soundness power.

Mr. GILLMOR. Okay.

Mr. COLBY. But if the Congress decides that's something that's appropriate for the bank regulators to have, we wouldn't oppose it.

Mr. GILLMOR. Let me ask Mr. Kohn. Mr. Leary said that it would be okay, in his view, to repeal the Bank Holding Company Act. Would you like to make the other case?

Mr. KOHN. I think I already did, Mr. Gillmor. And I will just repeat that I think the mixing of banking and commerce would be a very major step. The U.S.—Mr. Bachus cited two German firms that operate in a country in which banking and commerce have been closely integrated over the years. I think the U.S. financial system has benefitted considerably by having these two separate. We have a much more resilient financial system in which commercial firms have many avenues for raising funds that are not tied

to their banks. And as a consequence, I would tread very, very lightly on moving away from a formula that has given us, I think, a very safe banking system, a resilient financial system, one in which of course there are always difficulties and conflicts of interest, but have stayed away from some of the difficulties that could arise if we mixed banking and commerce.

I don't know that the answer is zero banking and commerce, but I think I would be very cautious about moving away from what Congress just looked at 8 years ago and made a very conscious decision that zero was the right number.

Mr. GILLMOR. Thank you very much. I was going to throw a softball to Chairman Bair, but my time has expired, so I yield back.

The CHAIRMAN. I thank the gentleman for his restraint. And I now recognize the gentleman from New York who has been very interested in this and has an issue that we're going to pursue. I guarantee him that at some point, it's going to get resolved; we're just not sure when. The gentleman from New York.

Mr. MEEKS. I was going to ask their opinion on that particular issue just to see what their interpretation would be on a hypothetical situation that I've been working with the chairman on. And that is, say there's a company that is primarily financial in nature. It receives its approval for an ILC to finance a particular service industry after October 1, 2003, but before 2007. The parent company receives some commercial revenue of less than 10 percent. In the years following 2007, the commercial revenue of the parent company exceeds 15 percent. Are there any restrictions upon the ILC once that 15 percent commercial revenue threshold has been reached or exceeded? What's your opinion?

Ms. BAIR. Well, this is a question about the construction of the legislation. As I understand it, if it's chartered between October 2003 and January 2007, it is not subject to the 15 percent. However, its business plan is frozen and it is prohibited from additional branching. So, even though the 15 percent commercial revenue limitation would not apply, it could not undertake new activities beyond what is already in its business plan, nor could it establish new branches.

Mr. MEEKS. Do you agree?

Mr. KOHN. Yes, I agree.

Mr. MEEKS. Okay. Let me ask Ms. Bair, do you believe that the FDIC currently has the authority that it needs to fully deny an ILC any future powers that it may request?

Ms. BAIR. Well, in terms of the activities of the ILC, yes. That is subject to exactly the same activity restrictions that other depository institutions are subject to. We're finding that most of the issues relate to commercial entities owning an ILC. But in terms of the ILC's activities itself, those are subject to the same restrictions.

Mr. MEEKS. And, Mr. Kohn, I know that you believe that we should separate—that commercial entities shouldn't own ILCs, etc. But say if, in fact, they continue to own them, who do you think should regulate them? Should it be the FDIC which currently regulates, or the Federal Reserve Bank, which has more experience with consolidation regulation?

Mr. KOHN. I think the most important thing is that someone should regulate the consolidated entity. That's my first point.

Mr. MEEKS. You should be up here. That's a political answer.

Mr. KOHN. Secondly, I think that if Congress were to give this authority to the FDIC, it would be creating another parallel regulatory environment. We already have both the Fed and the OTS regulating financial holding companies, depending on the nature of the subsidiary depository institution. This would create a third line of regulation, one that could define financial in a different way than the Federal Reserve defines financial.

So I would think Congress should think very carefully before creating another line of parallel regulation for consolidated entities.

Mr. MEEKS. Ms. Bair, do you agree?

Ms. BAIR. We are not seeking to become a holding company supervisor. We're happy to have the authorities should Congress decide to grant those to us. We have tremendous respect for the Fed. If we were given those authorities, we would consult with them closely. I agree. We would not want differentiations in how financial is defined.

I would also have to say that if you let the SEC in, you're going to have four. But, you know, I think the argument for allowing the FDIC to become holding company supervisor is that we do have the longest history with this industry, with these individual institutions. Also, the Fed already has two ILCs in holding companies subject to Fed supervision. Eight are under the OTS. And I believe four more would be under the SEC if you recognize them. So it would only be with regard to the remaining institutions where we would be having that role.

Mr. MEEKS. Thank you. I yield back.

The CHAIRMAN. The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Ms. Bair, in your testimony you specified that there are four categories of ILCs, and the fourth one is those that directly support the parent companies' or organizations' commercial activities and that they can maintain those entities by funding them, the parent, through forms of deposits, borrowings, and equity and so forth. How does your regulatory or oversight of those ILCs differ from the other ILCs that you oversee?

Ms. BAIR. Well, those types of applications obviously go through a very stringent Section 23A and 23B review. This is an area where we very closely consult with the Fed in terms of how to interpret and apply those provisions, and our supervisory program also heavily scrutinizes those relationships to make sure there is full compliance with 23A and 23B.

Mr. NEUGEBAUER. And have you ever experienced any problems with those relationships?

Ms. BAIR. There is one institution that comes to mind, though I don't like to talk publicly about individual cases. If you'd like to submit a question in writing, we can have our general counsel put something together to respond to that.

Mr. NEUGEBAUER. All right. Thank you. I guess this is a question to the panel as a whole. If we go forward with this legislation, we are going to, in fact, grandfather some institutions that came in under the previous regulation, and, therefore, if there are other or-

ganizations that would be, you know, competing with those organizations, in fact they are now going to maybe have a competitive advantage because they were grandfathered.

Is that good, fair, consistent policy for this country? And I'll just go down the—

Ms. BAIR. Well, I don't know how else to do it. You had to do it when you closed the non-bank bank loophole. You had to do it when you closed the unitary thrift loophole, and inevitably, there are going to be some winners and some losers.

Mr. KOHN. I agree with Chairman Bair. I think the problem, as she notes, is that you can't make everybody happy here. I think the most important thing is to cut things off. And there are people who have been operating under this charter for a while, and they should be allowed to continue operating under the charter.

But it would give them at least some competitive advantage against others, as I think Commissioner Leary was pointing out about the auto companies. But I think that's kind of the lesser of the evils. I'd rather have the loophole closed, people grandfathered in, and have no more going forward.

Mr. REICH. It would not be a perfect solution by any means, but it would—it is about the only option you have if you were to move in that direction.

Mr. COLBY. I have nothing to add to that.

Mr. LEARY. From my perspective, I don't believe the cutoff is needed.

Mr. NEUGEBAUER. Mr. Leary, if this legislation—because your State is one of the States that still allows that kind of activity—what do you see the impact moving forward with future ILC applications and activity in your State?

Mr. LEARY. With the commercial activity restricted? I would hope it would continue. I cannot predict how it would continue. I would simply indicate that while Utah may be an anomaly in that our commercial bankers and our industrial bankers are in the same association and work well together thus far in all of these operations, I would hope that it would continue.

Mr. BACHUS. Would the gentleman yield?

Mr. NEUGEBAUER. Yes, I would.

Mr. BACHUS. In the conversation about our automobile manufacturers, you said the only option would be to close the loophole and leave some in and some out. Obviously, what concerns many of us is that Ford and Chrysler are the two that do not have ILCs are our domestic producers, two of our three domestic producers. And our domestic automobile manufacturers, I think, are very important in a bipartisan way.

I guess there would be another solution, and that's as only to automobile manufacturers to allow a continuing or to allow a certain space of time to those that had made application. Any comment on that?

Mr. KOHN. I think I'd be a little concerned that once you crack the door, people would be pushing against it, and more would want to come in. So I do think the—

Mr. BACHUS. Of course if it were narrowly drawn and in that one regard. But I understand, it is a quandary.

The CHAIRMAN. If the gentleman would yield. My sense is, and I know the gentleman from Ohio and I have talked about this, my impression is that's an issue we will be dealing with when the bill comes out of the Senate. And sufficient unto the day is the evil thereof is, I think, the appropriate model there.

But I do think being realistic, there will be some Senate negotiations, and I think there will be some distinction drawn ultimately—this is a prediction—between those entities that are very limited to a kind of a self-financing situation in which they are processing some of their own paper, and entities that might seek a broader kind of franchise. But I do believe that's something we will be dealing with at that time.

Mr. BACHUS. Thank you. Because as you know, many members are concerned about that.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman. Let me start if I may by looking at this from a concept of what is in the best interests of the consumer. Because in the final analysis, that's really what we're here for. And that begs the question as to what is in the best interest of the consumer is the fact that the genie is sort of out of the bottle, because there are some companies who are already doing this.

What empirical data do we have that these companies provided a threat to our way of life, to the banking system? There has been none. You have Target; you have GE; you have Sears; and a number of others. But in fact, in some cases, the consumer has benefitted through added consumer convenience and lower costs in some areas. But in each of your testimonies, there has been consistent woe, but there has been no evidence, no empirical evidence that those who have the charter have been threatening to the system in any way. And I was wondering. And by that, Ms. Bair, I mean, wouldn't the FDIC, don't you think that they have the current oversight to make sure that these safeguards are there? And again, what evidence do we have that—

Ms. BAIR. Well, Congressman, you're right. To date, the commercially owned ILCs have a good safety and soundness record. They have been the source of product innovations and expansion of financial services to certain segments of the population.

I think what we're really talking about is prospectively how far you want to go with this. The current ILC exception is quite broad, and I think a lot of the concern about some of the pending applications that have gotten so much press and controversy has been not so much about what's currently being proposed, but what might happen in the future, where do we draw the line? Do you want major retailers being able to provide the full panoply of financial services?

We're being agnostic. Those are the kinds of policy issues that Congress needs to make. But, you know, I think they are good questions to be asking, and I think perhaps going forward, you do want to consider providing some limited ability to experiment with a very limited mixing of banking and commerce. Those are the right questions to be asking, but, again, we think it's a policy call for Congress to make.

Mr. SCOTT. Mr. Kohn, let me get to a point that you talked about in terms of some issues and complexities you said, conflicts of interest. Let us take an example. In the provision, isn't it true that the ILCs have what we call an anti-tying prohibition that is a safeguard?

Under this provision, an ILC could not condition a loan on a requirement that the borrower obtain services from an affiliate, and the affiliate could not tie a product sale to a requirement that the customer obtain banking services from the ILC. So, if the Home Depot, for example—it's a good example here, which I think as we move this process along, I think the bill will move forward. And when it gets to the Senate, there's going to be some deliberation. I agree with your point, but I do think that we ought not to sort of throw the baby out with the bath water here. But maybe to look at some of these situations on an individual basis.

So, for example, if the Home Depot were to operate an ILC, they could not require contractors to finance their supplies through the ILC, nor could the ILC require loan applicants to use the loan proceeds to buy supplies from the Home Depot. And I point this out because the anti-tying requirement for traditional banks, on the other hand, are applicable only to the bank itself.

So my—the point I want to make is that in some cases, for example, we take again the Home Depot case where this is going on now. I mean, it's basically a design to have a major consumer benefit. Now a consumer comes in, and they want to expand their line of credit. We're talking about a very small amount here that is certainly nonthreatening, but would be a major help to the consumer, to be able to transact his transaction there.

Now this same process happens, but in this case, Home Depot has to go and farm this out to, say, a CitiGroup or a bank like that, when you could have it here. And I think with the anti-tying provisions in here, there should be safeguards in and of itself.

Mr. KOHN. I think there are regulations in place and that could be put in place which help protect against this sort of thing. Now, whether they would really protect a consumer or a contractor who felt somewhat dependent on Home Depot, that consumer or contractor really felt that they had a fully panoply of choice and weren't being pushed into the financial offering that Home Depot was tying to its transaction, I think is an open question.

We've talked a lot about competition here, and the consumer. You've framed our question in terms of the consumer. There is a lot of competition in the financial services industry. There is relatively free entry into banking and thrifts. We charter hundreds of new institutions a year. I think if there is a need for financial services, there are people out there willing to start institutions or expand what they're doing—

The CHAIRMAN. Mr. Kohn, you have to wrap this up, please.

Mr. KOHN. Okay. That concludes my response.

The CHAIRMAN. Thank you. The gentleman from California, then the gentleman from Ohio. The gentleman from California.

Mr. SHERMAN. Thank you. I got a button yesterday, "Don't Mix Banking and Commerce." I got it from the Independent Community Bankers Association and I'd put in the record, but the pin would stick people.

And I've been interested to see the development of the whole idea of mixing banking and commerce. Because I've seen many bank regulators, particularly the Fed, be opposed to commercial institutions entering banking, and not nearly as opposed to banking institutions entering commerce. That is to say, when Wal-Mart wants to enter banking, the banking world says, Oh my God, look at Japan. Look at what happens when you mix banking and commerce."

But when banks want to go into real estate sales, auto sales, whatever, the bank regulators have been helping them, and we in Congress have stopped the presumed train wreck described by the community bankers when you mix banking and commerce. So perhaps you could comment, is it as bad an idea for bankers to get into commerce as for commercial organizations to get into banking?

Mr. KOHN. I think it would be a bad idea for bankers to get into commerce in a major way. What we allow now are commercial activities that are incidental to the basic financial activities of the banks. This is under the guidelines put out by Congress.

Mr. SHERMAN. But we could call anything incidental to banking. I bought this tie in a tie store, but I financed it on a credit card, and I hope before it wears out, I will pay off that bill. So it was a financial institution. In fact, the bank may make a larger profit on this tie than the haberdasher.

That being the case, is it your position that anytime you sell something that has to get financed—and I'd like to hear from your colleague sitting to your left as well.

Mr. REICH. I think we regulators are a pretty conservative group when it comes to banks expanding into a variety of commercial activities. We are not the cheerleaders for the banking industry to expand into commercial activities.

Mr. SHERMAN. Is there anyone on the panel who thinks that real estate sales is somehow incidental to real estate financing or is for some other reason not part of commerce? Let the record show there were no responses, and I yield back.

The CHAIRMAN. I thank the gentleman. The one example he did give might have been covered by the anti-tying rules.

[Laughter]

The CHAIRMAN. The gentleman from Ohio.

Mr. WILSON. No questions.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. Pass.

The CHAIRMAN. The gentleman from Utah probably doesn't want to pass. I would note again, the gentleman from Utah is not now a member of the committee, but we did get unanimous consent, given his interest, for him to participate.

Mr. MATHESON. And I would be remiss if I did not open by thanking both Chairman Frank and Ranking Member Bachus for their generosity in allowing me to participate today. It is very nice of you to do that.

I have all kinds of questions in 5 minutes, so we'll see how this goes. Mr. Leary, if you could just briefly confirm a couple of things for me. Number one, there were some references made in opening statements about lack of CRA participation by ILCs. Could you clarify what's really going on with CRA participation?

Mr. LEARY. I think from the State of Utah, and even from consumer activist groups, they would tell you CRA activity of the industrial banks in Utah is outstanding. They have been noted for proactive work. They are out there doing it the best they can. And what is unusual, while my background and experience is in community banking, the CRA group has sat down and tried to proactively figure out ways that create micro enterprise loan funds. They've created Utah Community Reinvestment Corporation. I think they've been very aggressive.

Mr. MATHESON. Thank you. I think it's interesting to note that from the chairman's opening remarks to just about everybody on the panel, I think everybody here has said that there's no safety and soundness issue to date in this industry.

And it reminds me of when we had the subcommittee hearing in the last Congress, and when then-subcommittee Chairman Bachus concluded the hearing, he said, you know, legislation is usually a solution to a problem, and it isn't clear where the problem is. He said that at the time, I'm not sure there is a problem. And I think that's the underlying question we need to be talking about today is where is the problem? Since we've all apparently stipulated there's no safety and soundness issue to date in this industry.

And yet, Mr. Leary, some people are concerned that only six States benefit. You've already said you wouldn't care if other States had access to this charter.

Mr. LEARY. I do not.

Mr. MATHESON. Is it your understanding that the beneficiaries of industrial-owned company services, namely, consumers, that those beneficiaries are in all 50 States, and in fact people throughout this country benefit from the industry?

Mr. LEARY. Yes they are.

Mr. MATHESON. Ms. Bair, I wanted to know, is it true—would you verify that the FDIC does in fact vigorously enforce Sections 23A and 23B in the anti-tying provisions applicable to the banks you regulate?

Ms. BAIR. Yes, we do.

Mr. MATHESON. You said you were agnostic about what we do. But you enacted a moratorium, and I don't know that that's agnostic.

Ms. BAIR. Yes.

Mr. MATHESON. And you've extended the moratorium, and if you ask Mr. Leary about what that's meant to people who are applying for charters, that is not a hold-harmless provision. That is not agnostic.

Ms. BAIR. Yes.

Mr. MATHESON. And I'm curious what's happened at the FDIC to sort of change this position? Because if you look at what your predecessor said, I quote remarks before State bank supervisors in 2003, after describing the FDIC's examination of industrial loan banks, he said, "These organizations are rigorously and sufficiently supervised by the state supervisors and the FDIC on an ongoing basis."

And then he addressed concerns about oversight of the parent companies. And he said, "While I understand these concerns, the FDIC has, and often uses, a number of tools to manage both the

holding company's involvement with the financial institution and to manage transactions between the two entities. We can and do visit the parent companies and other affiliated entities for that matter, to look over issues or operations that could impact the insured institution. Congress has given us the power to protect the integrity of those relationships. We have exercised that power, and we have coordinated closely with you, the State regulators, in our work. We have found parent companies of ILCs to be acutely conscious of their responsibilities with respect to their ILC subsidiaries and the consequences of violating applicable laws and regulations."

He has also said, "We at the FDIC must be vigilant in our supervisory role, but I will reiterate, the FDIC believes the ILC charter per se poses no greater safety and soundness risk than other charters."

Ms. BAIR. Yes.

Mr. MATHESON. What has changed?

Ms. BAIR. Well, I could read excerpts from the GAO report, from our own IG, from a number of members of this committee and in the Senate, and from a number of public commentors who would raise a lot of concerns about the current regulatory structure.

I felt when I came into this situation at the end of June last year that we needed to take a step back and evaluate all the issues, given that there were a lot of credible voices saying that the supervisory regime was not adequate.

And, Congressman, I do honestly think that this controversy about the ILC charter is not going to go away, because there are in fact no meaningful limitations on the FDIC's ability, other than safety and soundness considerations, to prevent major commercial entities from getting into banking in a very large way. That has not happened to date.

Mr. MATHESON. And you're questioning the FDIC's ability to adequately regulate, along with the State, those—

Ms. BAIR. I'm questioning whether the FDIC should be the decisionmaker in allowing major commercial retail entities to get into banking in a major way in this country. I don't think that's our decision right now.

Mr. MATHESON. Let me just ask if Congress did decide to allow this to happen instead of this legislation that's being proposed, do you think the FDIC has the adequate capability to regulate that industry in that context?

Ms. BAIR. We will have to evaluate each application on a case-by-case basis. But any decision we made would have to be based on safety and soundness considerations. It couldn't be based on policy considerations relating to commercial ownership.

Mr. MATHESON. Do you think that the commercial ownership issue has evolved in the last few years due to a particular application?

Ms. BAIR. Our decision wasn't driven by any individual applications, but there has been a trend and greater interest in this charter by major retailers, yes.

Mr. MATHESON. Do you think that when you look at FDIC and the bank-centric model that we've had here, do you see areas that we—or capabilities that you don't have now that would help you

better regulate this industry, or are you satisfied with the tools you have at your disposal?

Ms. BAIR. I think holding company authorities, particularly the ability to examine affiliates, would be helpful, yes, I do.

Mr. MATHESON. And you don't think you have that—

Ms. BAIR. We do not have that now, no. We have—

Mr. MATHESON. Do you take issue with what your predecessor said about that?

Ms. BAIR. Well, our ability to examine affiliates is only with regard to determining what the relationship is with the ILC. So unless there's a relationship, we could be challenged in our ability to examine affiliates.

Mr. MATHESON. Okay. Mr. Chairman, I see my time has expired, and I do not want to abuse the privilege. Thank you so much.

The CHAIRMAN. I thank the gentleman. And with that, we will thank the witnesses. Did the gentleman from Illinois wish to ask questions? Then we thank the witnesses very much, and we will ask them to leave expeditiously, and we'll empanel the next panel. And everybody who wants to be polite to each other, do that in the hall. Just leave quickly.

We ask people to leave quickly. Don't black the aisles, one panel to the next panel. We'll try to do as much as we can before we're interrupted for votes. And let us have the next panel be seated, please.

Would the members of the panel please move up here and be seated so we can get started? Would the people to the Chair's left please leave? Thank you.

The second panel will begin. We will ask that those doors be closed. And the first witness is Ms. Amy Isaacs, who is the national director of Americans for Democratic Action.

Please just sit down and let us start talking, guys. Come on, we're in a hurry.

Ms. Isaacs.

Excuse me. Members of the staff, close those doors, please. People either seated, or on the other side of the door.

Thank you. Please continue.

STATEMENT OF AMY ISAACS, NATIONAL DIRECTOR, AMERICANS FOR DEMOCRATIC ACTION

Ms. ISAACS. Mr. Chairman, thank you. I appreciate the opportunity to testify representing our more than 65,000 members. Unlike my colleagues on this panel and the preceding one, I am not an expert in banking. I am, however, a consumer, as are the members of my organization. And because we are concerned about the impact that granting an ILC charter to any retail enterprise could have on individual consumers and small business, we endorse H.R. 698, the Industrial Bank Holding Company Act of 2007.

Although H.R. 698 is not specifically about Wal-Mart, I will focus on Wal-Mart as perhaps the most pernicious example of the problems which can arise when banking and commerce are intertwined. We believe a bright line between the two must be drawn.

Wal-Mart's recently withdrawn application to enter the banking business was fraught with risk, which would have been guaranteed by American taxpayers. A bank tied to one of the world's largest

retailers would face unique commercial and reputational risks. Regulatory agencies charged with supervising these risks lack the experience or the capacity to understand how to evaluate or minimize them.

Giant retailers have been forced into Chapter 11 or have disappeared because of changes in the commercial environment. K-Mart, Ames, Woolworth, and Montgomery Ward are examples of retailers who have reorganized or have disappeared. Business models change, as do consumer preferences. The Federal Government is not and should not be in the business of understanding the risks of large-scale retailing. It should not have to worry about the safety and soundness of a global retail business, dependent on complex global supply systems. If the retail operation faces disaster, so will the bank.

Wal-Mart also faces the risk of social ostracism for its routine antisocial behavior. Wal-Mart has an established pattern of irresponsible practices. It shorts employees on health care, it has flouted hourly wage laws, and it has been involved in multiple cases of alleged discrimination. The company has been accused of using undocumented workers and a senior executive said he padded his expenses to conceal anti-union expenditures.

Such behavior carries the risk of a damaged reputation, and with it, a run on the bank. The government cannot be in the position of insuring against the risk. There are many other examples of antisocial behavior leading to the demise of financial institutions. Riggs Bank is a prime example.

We also are deeply concerned that large scale commercial enterprises could misuse their market power. As state-chartered ILCs, they would not be subject to the stricter regulations of bank holding companies. They could use their position in the marketplace and control of prime real estate for their own advantage, instead of the interests of the community they purport to serve.

Had Wal-Mart been granted an ILC charter, it would have been able to offer anything an ordinary bank could—savings accounts, checking accounts, mortgages, and a variety of loans for everything from home improvement to car purchases to small business loans. The potential for conflict of interest is obvious.

Would retailers make loans to competitors? Should they have access to credit information about competitors?

Retailers operate with the goal of dominating markets. They work to control competition. The result has been the extinction of long-term community small businesses. There is no reason to believe that a foray into banking would have a different outcome.

Retailers are not offering banking services to save consumers money. They are not charities. They are in business to make money. They want to use their retail power to muscle their way into the financial services industry.

Had Wal-Mart been granted a charter, it would have used its power to muscle past community banks and credit unions, which do care about their own communities. Among the factors the law requires be considered in accepting an application for an ILC charter is the convenience and needs of the community to be served. Mixing retail commerce and banking makes it impossible to meet that standard. The conflict of interest and the push for market

dominance argue against a charter serving any need or convenience other than the retailers'.

Existing institutions leasing space in retail stores serve customers. Many banks have arrangements with supermarket chains. These bank branches meet the needs of both consumers and the community.

Wal-Mart saw the handwriting on the wall when it withdrew its application. But until and unless H.R. 698 is signed into law, we cannot guarantee that a similar problem will not recur. Americans for Democratic Action stands for liberal values. We see bank regulation as an area where true conservative values should prevail. By granting a charter and deposit insurance, the government should not be risking regulating a business it does not understand. It should not insure depositors against a corporation's antisocial behavior and the attendant risks.

For these reasons, Americans for Democratic Action urges passage of H.R. 698. Thank you for your consideration.

[The prepared statement of Ms. Isaacs can be found on page 113 of the appendix.]

The CHAIRMAN. Thank you.

And next, testifying on behalf of America's Community Bankers, for the chairman a familiar face, not to mention accent, one of our leading bankers in Massachusetts, Arthur Connelly from South Shore Bank.

STATEMENT OF ARTHUR R. CONNELLY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SOUTH SHORE BANCORP MHC, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. CONNELLY. Thank you. Chairman Frank, Ranking Member Bachus, and members of the committee, thanks for inviting me to testify before you today on the Industrial Bank Holding Company Act of 2007.

My name is Art Connelly, as the chairman said. I am the chairman and CEO of South Shore Bancorp, and I also serve as the first vice chairman of America's Community Bankers, and I am here today to testify on their behalf.

The appropriate regulatory structure for industrial loan companies is incredibly important and should be addressed by Congress. First, I want to say that ACB strongly supports H.R. 698. We believe that this commonsense legislation is necessary to improve the safety and soundness of the banking system. ACB believes that the withdrawal of Wal-Mart's ILC application does not end the need for comprehensive ILC regulatory reform.

The ILC charter is the only bank charter that can be obtained by a commercial entity. Furthermore, there is no holding company oversight for ILCs that are not otherwise supervised by the OTS or the Federal Reserve.

These structural issues run contrary to legislation passed by Congress. Consistently throughout the 20th century, Congress made it clear that it does not want commercial ownership of banks in the United States and wants insured banks to have consolidated holding company oversight.

There are good reasons to have concerns about commercial ownership of banks, especially with ILCs. Commercially owned banks

can face conflict of interest pressures from their commercial owners. We have seen this problem in other countries, where a commercially owned bank can be pressured by its parent to make loans based not on sound underwriting but on the needs of its commercial parent. Concerns about the payment system integrity might also exist if a commercial parent improperly influences the actions of an ILC subsidiary that processes payments.

Furthermore, these problems are greater for ILCs because commercially owned ILCs that are not affiliated with a bank or a savings association have no holding company regulator that can help oversee risks to the depository institution on a consolidated basis. While the FDIC has done an admirable job in regulating ILCs for safety and soundness so far, it does not have the statutory authority to examine the parent company.

The recent surge in commercial ILC application brings these concerns to the forefront. Until recently, the majority of ILC asset growth has been in ILCs that are affiliated with banks or savings associations and have holding company supervision. If no regulatory supervision is passed, we could see dramatic growth in commercially owned ILCs with no holding company oversight.

That brings me to H.R. 698. On examining the bill, it is helpful to look at Gramm-Leach-Bliley, where Congress prohibited any future ownership of unitary thrifts by commercial companies. However, Congress grandfathered all unitary thrifts that were commercially owned prior to 1999. This appears to be the model for the Industrial Bank Holding Company Act, and we believe it to be a fair one.

H.R. 698 creates an FDIC regulated holding company structure for ILCs not regulated as a bank or a savings and loan holding company. Providing the FDIC with the authority to supervise the parent companies of these ILCs on a consolidated basis will allow it to ensure the safety and soundness of the institution. The legislation also utilizes a grandfathering system similar to the one in Gramm-Leach-Bliley.

In conclusion, Mr. Chairman, we believe H.R. 698 is sound legislation that will fill a current gap in our financial regulatory structure. I will gladly take any questions that you might have. Thank you.

[The prepared statement of Mr. Connelly can be found on page 82 of the appendix.]

The CHAIRMAN. Thank you. Next, from the Independent Community Bankers of America, Mr. Jim Ghiglieri. Please, Mr. Ghiglieri.

STATEMENT OF JAMES P. GHIGLIERI, JR., PRESIDENT, ALPHA COMMUNITY BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. GHIGLIERI. Mr. Chairman, Ranking Member Bachus, and members of the committee, my name is Jim Ghiglieri, and I am president of Alpha Community Bank in Toluca, Illinois. I am also chairman of the Independent Community Bankers of America. ICBA is pleased to have this opportunity to testify.

The ILC charter threatens our Nation's historic separation of banking and commerce and undermines our system of holding company supervision. The fact that Wal-Mart has withdrawn its ILC

application does not diminish the need to act. Other applications are pending and more could be filed.

ICBA was pleased that the FDIC unanimously adopted the recommendations of Chairman Frank and Representative Gillmor and many of their colleagues to impose a 1-year moratorium on ILC applications by commercial firms. The entire FDIC Board clearly recognizes that these applications raise broad public policy issues that Congress must confront. Congress can do that by enacting H.R. 698.

Like much good legislation, H.R. 698 is a compromise. That is its strength. Institutions that are already in business could remain in place. Financial companies could continue to acquire, establish, and operate ILCs. The legislation addresses the key concerns without needlessly disrupting ongoing activity, and it gives the FDIC the basic tools it will need to be an effective consolidated regulator.

Why do we ask Congress to pass this bill? First, the loophole threatens the safety and soundness of the financial system. Second, mixing banking and commerce presents serious conflicts of interest. Third, ILCs could destabilize local communities and harm consumers. Fourth, ILCs could jeopardize the payment system. And, fifth, ILC holding companies need stronger regulation.

Let me briefly elaborate. First, safety and soundness. Allowing commercial firms to own federally insured ILCs adds tremendous new risk to the Deposit Insurance Fund. For example, Ford Motor Company applied for an ILC charter. Ford's financial difficulties are well-documented. Banking regulators will not allow banks to buy Ford bonds. Ford hardly sounds like a source of strength for an FDIC-insured ILC.

Home Depot and its ILC acquisition target are susceptible to fluctuations in real estate. According to Bloomberg News on February 21st, and I quote, "Home Depot reported its biggest drop in quarterly profit as the decline in U.S. home sales sapped demand for building supplies."

Financial services regulators, no matter how competent, do not have the expertise to understand each of these economic areas and protect the safety and soundness of an ILC from problems that may befall its parent. A financial regulator should not become involved in market decisions of a major commercial firm.

Second, conflicts of interest. Home Depot could be tempted to direct its bank to offer unsound loan terms to its customers provided they agree to purchase products from Home Depot. Or Home Depot could offer discounts on its product if a customer takes out a loan from its bank. The idea that a bank should be an objective credit grantor gets thrown out the window either way.

Third, harm to consumers and communities. An ILC owned by a retail firm is unlikely to make loans to its local competitors. An ILC with a nationwide deposit taking network could draw funds out of local communities, sending them to corporate headquarters. Major commercial firms have the size and resources to engage in predatory pricing for as long as it takes to drive local competitors out of the market, both locally owned small businesses and community banks.

Fourth, the payment system. The Wal-Mart application highlighted potential risk to the objectivity and security of the payment

system. If retailers control the payment system, they will seek competitive advantage rather than control risk. Consumers, small businesses and banks of all sizes would be the victims.

And finally, lack of regulatory authority. The FDIC currently lacks clear statutory authority to consider all of the broad policy implications when considering ILC applications and to regulate ILC holding companies.

While ICBA believes that the FDIC has ample grounds under current law to deny several of the pending applications, especially Home Depot's, it may eventually be compelled to grant a disturbing number of them. 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. But that is rapidly changing. A GAO report highlighted the need for enhanced supervision of ILCs, especially the need for consolidated supervision over both the ILCs and their holding companies. Successive Federal Reserve chairmen have repeatedly made similar points.

Congress has ample precedent for closing the ILC loophole. You closed the non-bank bank loophole in 1987 and closed the unitary thrift loophole in 1999. Now it is time to close the ILC loophole.

Thank you very much.

[The prepared statement of Mr. Ghiglieri can be found on page 95 of the appendix.]

The CHAIRMAN. Thank you.

Next, Mr. McVicker, who is the chairman and CEO of the Central Bank and Trust Company, and he is testifying on behalf of the ABA, the American Bankers Association.

Mr. McVicker.

STATEMENT OF EARL D. McVICKER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CENTRAL BANK & TRUST COMPANY, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. MCVICKER. Mr. Chairman, and members of the committee, my name is Earl McVicker. I am chairman and CEO of Central Bank and Trust Company in Hutchinson, Kansas, and chairman of the American Bankers Association. Thank you for the opportunity to present ABA's views on the regulation of ILCs.

Since Congress last enacted legislation concerning the ownership of ILCs nearly 20 years ago, the ILC industry has changed dramatically. Unfortunately, these changes now threaten to undermine the separation of banking and nonfinancial commerce that has long been a feature of U.S. law. In fact, over the last 50 years, Congress has repeatedly curtailed the ability of nonfinancial commercial firms to engage in banking activities.

In each of these instances, the legislation was a reaction to nonfinancial firms that were taking advantage of statutory provisions to engage in banking. Moreover, in each instance, Congress was consistent in enacting legislation to maintain the separation between banking and nonfinancial commerce.

Today, unintended use of the ILC charter has made it necessary for Congress to act once again to maintain this separation. When the term bank was redefined in 1987, ILCs were specifically excluded from the definition. At that time, most ILCs were small. And the few States that were able to charter ILCs were not pro-

moting the charter. Simply put, there was no significant risk that problems caused by mixing banking and nonfinancial commerce would arise at the time the exemption was codified.

That is not the case today. By the end of 2006, aggregate ILC assets totaled almost $213 billion, an increase of more than 5,500 percent since 1987. The average ILC now holds close to $3.7 billion in assets.

Recent ILC asset growth is no accident. When Congress cut off the ability of nonfinancial commercial firms to engage in banking through unitary thrifts in 1999, these firms were forced to look for other means of doing so. It is no coincidence that total aggregate ILC assets more than doubled from $44 billion in 1999 to over $90 billion in 2000. Clearly, with the closure of one avenue into the banking world, nonfinancial commercial entities began to exploit another.

It is fair to assume that Congress did not anticipate that the ILC exemption would be used for this purpose. There is a significant risk if the separation is not maintained. A nonfinancial parent, seeking to further its commercial pursuits, could put depositors' funds, the capital of the bank and the deposit insurance fund at risk.

Congress has recognized these risks and should once again act to preserve the separation of banking and nonfinancial commerce by closing this exemption. Thus the ABA supports the Frank-Gillmor bill, H.R. 698, which would create a general rule that commercial firms may not own an ILC. The bill would grandfather commercial firms that currently own an ILC, and we support bringing grandfathered institutions within the jurisdiction of a Federal bank regulator, and vesting that regulator with the full range of supervisory and enforcement tools.

We stand ready to work with Congress to maintain the important separation between banking and commerce. Thank you.

[The prepared statement of Mr. McVicker can be found on page 172 of the appendix.]

The CHAIRMAN. Thank you very much, Mr. McVicker.

Next, John Douglas from Alston and Bird, who is testifying on behalf of the American Financial Services Association.

STATEMENT OF JOHN L. DOUGLAS, ALSTON & BIRD LLP, ON BEHALF OF THE AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. DOUGLAS. Mr. Chairman, and members of the committee, thank you very much for allowing us to present testimony on this important bill.

American Financial Services Association is the national trade association representing many of the Nation's most important lenders, providing access to credit for millions of consumers and small businesses. AFSA strongly believes that the industrial bank option represents a safe and sound and appropriate means to deliver financial services to the public.

Congress established a framework within which commercial companies can provide deposit, loan, and other banking products to their customers. This framework is highlighted by stringent and appropriate supervision, by strong enforcement powers, and by a

structure of laws and regulations that mitigate the consequences of the hypothetical and unproven evils raised by the opponents of commercial ownership of industrial banks.

I testified on this issue last year and don't intend to repeat my testimony. Since that time, we've endured a lengthy moratorium by the FDIC and a long comment period where the FDIC sought guidance on how to deal with this important issue. There were thousands of comments, most in opposition.

It is important to recognize, however, that nothing, no event, no failure, no fact, lends any substance to the allegation of the great dangers to our economy that would result from commercial ownership of industrial banks. Indeed, all we have is speculation.

There are three main allegations. First, that there is some gap in our supervisory framework that poses danger to our economy and banking system. Second, that if commercial companies are allowed to own industrial banks, rampant tying or other unseemly activities would occur and the FDIC couldn't stop them. And, third, there is something fundamentally un-American and dangerous about mixing banking and commerce. I respectfully submit that these allegations are not true.

First, industrial banks are subject to the same comprehensive framework of supervision and examination as normal commercial banks. They have no special powers, no special authorities, and are exempt from no statute or regulation. They comply with 23A and B, regulation O, capital requirements, prompt corrective action, anti-tying provisions, and the Community Reinvestment Act.

Second, the FDIC has been given full and ample authority to supervise and regulate these institutions and can exercise the full range of enforcement powers. I was a participant in the political process that led to a rewrite of these provisions in 1989 as part of FIRREA and it was our intention to give the FDIC and the other regulators all the enforcement powers they needed, which they exercised.

Third, I can attest from experience that the FDIC does exercise these powers. It requires an independent board, adequate capital, safe and sound operations, and effective internal audit. It examines, it scrutinizes, and it exercises its powers to protect our system.

And finally, the FDIC's experienced with industrial banks, similar to the experience of the OTS with respect to diversified owners of savings associations, belies any fundamental concerns to threats to our banking system. This is a well-capitalized, well-managed segment of the industry, making important contributions to consumers and small businesses. The FDIC's experience has been good.

Finally, I want to address once more this myth of separation in banking and commerce. The Gramm-Leach-Bliley Act, to say that it was designed to make permanent that separation, is to ignore important provisions of that Act. There have always been affiliations and relationships between banking and commercial firms. These relationships have been carefully reviewed by Congress.

If we were serious about eliminating it, we would preclude our banks from being affiliated with any entity. We wouldn't let Bank of America be affiliated with Bank of America securities, lest it

favor its customers over those of Merrill Lynch. We would more closely scrutinize the propriety of a small business owner, a real estate developer, a car dealer owning a commercial bank in a small community, where sources of credit are lax.

If we were really concerned, we would repeal the merchant banking powers in Gramm-Leach-Bliley and repeal the FDIC's power to grant commercial activity—permit commercial banks to engage in commercial activities in FDICIA. It is anomalous at best to be asserting that there is something wrong with a commercial entity engaging in banking when we have opened the door broadly and widely for banks to engage in and invest in commercial activities.

I want to emphasize this last point. It is permissible under current law for any one of a number of banking organizations to use their powers granted under Gramm-Leach-Bliley to acquire any commercial entity. This bill would preclude any commercial entity from establishing a bank to facilitate the needs of meeting its customers, regardless of the size of the bank, the needs of its customers, or any other factor that might benefit our economy or our communities.

I would submit that the breadth of our markets and the strength of competition in our financial services industry has served us well and submit that it would be unwise to roll back the clock by taking steps to limit competition in this area. Thank you very much.

[The prepared statement of Mr. Douglas can be found on page 87 of the appendix.]

The CHAIRMAN. Thank you, Mr. Douglas.

And next, Mr. Marc Lackritz, who is the chief executive officer of SIFMA.

STATEMENT OF MARC E. LACKRITZ, CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman. I appreciate the opportunity to testify today before the committee, because the SIFMA members own a vast majority of the industrial bank assets in the United States. And as you know, Mr. Chairman, Congress passed Gramm-Leach-Bliley back in 1999 to allow affiliations between and among securities firms, banks, and insurance companies, combined with functional regulation.

This ability to structure their operations optimally within existing law has really been critical to the success of industrial banks and their owners. Many of these companies are among the most advanced, sophisticated, and competent providers of financial services anywhere. And we support the ability of regulated securities firms to continue to own industrial banks the way they do under existing law.

Federally insured industrial banks are subject to State banking supervision, FDIC oversight, and all the banking laws that govern relevant banking activities. Most importantly, the FDIC has the authority to examine the affairs of any affiliate of any depository institution, including its parent company.

The FDIC's regulation of industrial banks has proven safe and effective. Industrial banks do not pose any greater safety and soundness risks than any other charter types and should not be

subject to additional constraints beyond those imposed on other FDIC insured institutions.

H.R. 698 would create a new holding company regime for the owners of industrial banks by expanding the existing authority of the FDIC over the owners of these institutions. Bank and thrift holding companies that own industrial banks would be exempted from this regime, presumably because they are already subject to holding company oversight by the Fed or the Office of Thrift Supervision. However, the bill fails to provide an exemption for industrial bank owners who are regulated as consolidated, supervised entities by the SEC.

We believe it is critical that H.R. 698 be amended to recognize the SEC's CSE regime. The Commission established its CSE framework in 2004 in part to allow major securities firms doing business in the European Union to comply with its financial conglomerates directive. That directive requires that non-European firms doing business in Europe demonstrate that they are subject to a form of consolidated supervision by their home regulator that is equivalent to that required of their European counterparts.

The GAO found in its recently released report on CSEs that the Federal Reserve, OTS, and the SEC were generally meeting criteria for comprehensive consolidated supervision. We agree that the CSE regime is both robust and comprehensive. Importantly, the Commission's CSE oversight, just like the Federal Reserve's oversight of bank holding companies, meets the EU's equivalency standard. In addition, the SEC's consolidated regulation standards closely parallel the Fed's standards to assess whether a foreign regulatory regime qualifies as consolidated regulation for a foreign bank operating in the United States.

We therefore strongly urge the committee, Mr. Chairman, to recognize the SEC as a consolidated regulator along with the Federal Reserve and the OTS in H.R. 698. The SEC is recognized worldwide as a consolidated regulator and its regulatory requirements and procedures were very carefully designed to comply with all standards for effective consolidated regulation in the United States and abroad. That stature should be reflected in this bill, in order to ensure that global securities firms are not damaged inadvertently.

Over the last 2 decades, capital markets and the financial services industry have become truly global, integrated, and interconnected. As capital markets and financial products continue to evolve, so too must our Nation's regulatory structure. We need a regulatory regime that is capable of keeping pace with rapid globalization, technological transformations, and dynamic market changes. That is why our new board of directors unanimously agreed that we will develop a long term strategy of seeking to modernize financial services regulation and deal with inconsistencies in the current regulatory system.

We look forward to working with financial market participants, regulators, and legislators, and you, Mr. Chairman, to ensure that our financial services industry retains its preeminent status in the world. Thank you very much, Mr. Chairman.

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

The CHAIRMAN. Thank you. And next is Mr. Thomas Stevens, who is the immediate past president of the National Association of Realtors.

STATEMENT OF THOMAS M. STEVENS, IMMEDIATE PAST PRESIDENT OF THE NATIONAL ASSOCIATION OF REALTORS

Mr. STEVENS. Thank you, Mr. Chairman, and committee members. Thanks for allowing us to do the soft shoe there.

My name is Tom Stevens. As the 2007 immediate past president of the National Association of Realtors, and former president of Coldwell Banker Stevens, I am here today on behalf of the more than 1.3 million Realtors who work in all fields of commercial and residential real estate.

The National Association of Realtors wholeheartedly supports H.R. 698 as it closes a loophole that allows commercial companies such as Home Depot to own state-chartered, federally insured banks. Perhaps more importantly, the Industrial Bank Holding Company Act of 2007 would restore one of our Nation's most fundamental economic principles, the separation of banking and commerce.

I also thank Representative Gillmor for his dedication to pursuing a legislative solution to this important issue, which was raised more than 4 years ago.

Let me be clear. Realtors have long supported the national policy against the mixing of banking and commerce. We oppose any efforts to weaken this policy, either by allowing commercial firms to engage in banking, or by permitting large national banks to engage in commercial activities, such as real estate brokerage and management.

Realtors believe banking and commerce should remain separate for three key reasons. First, we strongly believe that allowing commercial firms to engage in banking would create inherent and irreconcilable conflicts of interest.

Second, Realtors believe that giving large commercial firms the benefits associated with owning a federally insured bank would stifle competition in the marketplace. For example, if an ILC owned by a commercial firm provided loans on more favorable terms to suppliers or customers of its parent, it could put other commercial firms at a disadvantage. Likewise, allowing national banks to engage in commercial activities such as real estate would stifle competition from nonbank firms that do not share such benefits.

Third, we believe that mixing banking and commerce poses substantial risks to the financial system. Over the last few years, regulators at the Federal Reserve, the OCC, and the FDIC have considered giving banks the green light to engage in commercial activities. We believe such activities markedly increase the risk exposure of national banks and could threaten the safety and soundness of the entire banking system.

Banks should be in the business of banking, not selling cars, home improvement supplies, or real estate brokerage. When banking activities and commercial activities and commercial activities mix, it can be a recipe for disaster, bad for the economy, bad for businesses, and bad for consumers.

Realtors applaud Representative Gillmor and Chairman Frank for taking the lead in this important issue. And we urge the House Financial Services Committee to pass H.R. 698, the Industrial Bank Holding Company Act of 2007.

We also encourage Congress to pass H.R. 111, the Community Choice in Real Estate Act, which would similarly prevent large banks from entering the real estate business.

And I want to thank you for your time and would be more than happy to answer any questions.

[The prepared statement of Mr. Stevens can be found on page 200 of the appendix.]

The CHAIRMAN. Thank you, Mr. Stevens.

I am not, myself, going to ask questions. I want to assure the panel it is not for lack of interest in what they say. Some of us have been working on this for some time. There are newer members who have concerns. I think we have had some serious conversations.

So with that, I am going to turn to the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you. I—maybe the arguments here should be centered not on safety and soundness which, Mr. Douglas, you were talking about and Mr. Ghiglieri, among others. The issue here is how big are you going to get before you smash the little guys?

Mr. Ghiglieri, do you want to take a stab at that question? Isn't that the issue?

Mr. GHIGLIERI. This is not an issue of competition. We are not and never have been afraid of competition. We compete with every financial services provider out there, from the big banks to the ILCs to credit unions to payday lenders.

This is really about two issues, and that is maintaining the separation of banking and commerce, and providing a consolidated regulator at the holding company level for ILCs. But it is not about competition; we are not afraid of competition.

Mr. MANZULLO. Okay. Some have called this the bank of Wal-Mart. And some of the bankers that I have talked to have expressed a concern that when you get commerce on that level, that indeed will hurt competition, or if not competition, the ability to discern on the type of loan that should be given. Anybody want to take a stab at that?

Mr. MCVICKER. It is really not about competition; it is about the issue that has been addressed from numerous panelists and the concern there is some safety and soundness risk, we believe, to the industry and to the FDIC fund.

What Wal-Mart would be doing if they were approved remains to be seen. But our position was the same before Wal-Mart filed their application and remains the same after it has been withdrawn. And that is the concerns, the safety and soundness both of the regulatory system and the deposit insurance fund.

Mr. MANZULLO. Mr. Douglas?

Mr. DOUGLAS. I would say that if we're concerned about threats to the deposit insurance fund, there is certainly no evidence that industrial banks pose that threat. And if we look historically back the same 20-year period we've been looking at for commercial banks, one would say that consolidated supervision might pose a

greater threat to our safety and soundness than an industrial bank.

Virtually every financial institution that has failed in the last 20 years has been subject to consolidated supervision. The point is not that the Fed is a bad regulator or that the FDIC is a better regulator. The point here with industrial banks is that the FDIC and the States with their bank centric level of supervision has proven to be a pretty effective way of protecting our financial system.

Mr. MANZULLO. Do you agree with that Mr. Ghiglieri?

Mr. GHIGLIERI. Yes. I just think that it is a mistake to look backwards at the ILC industry and say that the system is necessarily sound because there have been no failures. I think we can all shudder to think what would have happened if WorldCom or Enron would have had an ILC. Or, going forward, if the ILC industry continues to expand like I think all of us think would happen. And I think that is where the threat to the deposit insurance comes in.

Mr. MANZULLO. Give us the worst possible scenario, if ILCs were allowed. I mean, it is obvious that you oppose them. Obviously, you oppose them.

Mr. GHIGLIERI. Well, I think you can look at the Japanese or the German model. In Japan, I remember as a young banker back in the 1970's listening to expert after expert and report after report talking about this wonderful Japanese economic model in this, you know, incredible Japanese banking model that was really built on commercial firms owning banks. It was projected to be the greatest economy the world would ever know and they were going to come to the United States and buy New York City brick-by-brick.

And as we reflect back on that model, I think we can all agree that it has been a complete disaster. They've been stuck in a 20-year recession and really have no hope of getting out of it. The banking system is, in effect, insolvent. And I just—I can't imagine that is the system that we want for this industry that I love and am so passionate about.

Mr. MANZULLO. What is the difference between an independent bank having a presence in a Wal-Mart store and, for example, the Wal-Mart store owning the bank itself?

Mr. GHIGLIERI. In a concept like that, it is—you know, a lot of us have members that lease out space in Wal-Mart—it doesn't have to be Wal-Mart, it is a grocery store. There are all kinds of those operations. But those are just strictly bank branches. They lease out space and they sell their products and services. So it is much different than those commercial firms owning those branches.

Mr. MANZULLO. Mr. Douglas? I am trying to get a fight going here, but you guys won't put the gloves on.

Mr. DOUGLAS. Well, the truth of the matter is, Wal-Mart is attempting to meet the needs of its customers, were Wal-Mart to do this, the same way a commercial bank is trying to meet the needs of its customers, by finding locations where people can access products and services in a way that is convenient to them.

One might say that one is better or worse than the other, but they are both subject to the same framework of laws and regulations. I find no fundamental unfairness or difference associated with one over the other.

Mr. MANZULLO. Mr. Lackritz?

Mr. LACKRITZ. I would just say that I think the challenge you have is, and I think someone said it earlier on the earlier panel, that this thing, it is getting big and business is getting larger daily and moving at a faster pace. And I think the challenge you have is when you have a Wal-Mart that now owns a bank and you have conflicting interests, everything is great when things are going along well. You know, so was the real estate industry last year when things were going along well, and now there are challenges. And then the little things, subprime lending, those kinds of things start to crop up.

But when you start to have that major corporation have some challenges and conflict, then there is a conflict with its subsidiary company or the bank that it owns, and you could have diverse decisions being made or decisions being made that aren't in the best interests of the bank or the bank's customers, versus the consumer of the goods out there.

So I think it is an inherent conflict that you face.

Mr. MANZULLO. Thank you.

The CHAIRMAN. I am going to recognize Mr. Matheson. I would just say that, in response to what Mr. Douglas said, the difference to me is in the incentives to which the economic entity responds, and that is the question, whether or not the incentive is that you make money off the loan and also off the product that is going to be bought with the loan and the extent to which that is going to alter that decision. That is the difference. And obviously, people keep talking about Wal-Mart, and it is true that Wal-Mart has withdrawn its application, but that does not change our view.

I would note, however, in legal terms, Wal-Mart has withdrawn its application without prejudice. I think it is very clear that the reason Wal-Mart withdrew its application is that friends of the ILC industry said to Wal-Mart, will you please stop screwing up our industry because you are making everybody mad and would you go away. And they have withdrawn but they have not disappeared. And if we were, in fact, I think, finally to announce that there would be no such legislation and no moratorium, Wal-Mart would have every right in the world to come back in again.

Mr. Matheson.

Mr. MATHESON. Thank you, Mr. Chairman.

I just wanted to clear up one issue that came up in the subcommittee hearing last year as well, and that was comparing the Japanese model to ILC regulation. And I asked the panel of regulators in the subcommittee hearing last year if it's comparable and they said, no. So it is not exactly the same type of regulation. Would you agree with that, Mr. Ghiglieri?

Mr. GHIGLIERI. That may be the case. I mean, I am not a regulator.

One thing that I do take issue with is this concept that ILCs and all of the rest of us are regulated the same way. We are regulated the same way at the bank level. But we have tremendous regulation at the holding company level and for a bank our size, it is a tremendous cost.

Mr. MATHESON. I think everyone stipulates to that, that there is a different model of regulation. It is called bottom-up for ILCs; it is top-down for other banks. And again, I don't think anybody on

this committee disagrees with that. The question is, is one right and one wrong, or is there more than one right way to do something? And I think you know where I am coming from on that.

But I think it is just important that we note the ILC model and the way we regulate in this country, I would not say that is the Japanese model. I just think we ought to have that for the record.

You mentioned in your written testimony and your verbal comments, Mr. Ghiglieri, imagine if WorldCom and Enron had banks. And I would submit that instead of coming up with imaginary scenarios that sound pretty bad, let us look at the real scenario of when Tyco and Conseco had banks, as Mr. Leary mentioned in the previous panel. Are you familiar with that experience, where the parent companies had financial difficulties, one went into bankruptcy, and in both cases the ILC was separated from all those financial troubles? Actually, one sold as a premium after the fact?

Mr. GHIGLIERI. Yes.

Mr. MATHESON. Okay, so that's a real world example, compared to imagining scenarios. And I think that's important to point out, that the bottom-up regulation worked in those circumstances.

Are you familiar with regulations 23A and 23B?

Mr. GHIGLIERI. Yes, I am.

Mr. MATHESON. Because in your testimony where you talk about how Home Depot may pressure people and that, do you recognize that would be a violation of existing law?

Mr. GHIGLIERI. Correct.

Mr. MATHESON. Okay. I just wanted to confirm that.

Mr. GHIGLIERI. And if I could just add to that? I think it is one thing to have a corporate decision that there would be no violation of 23A. But, you know, I think when you get down to the store level, when you get an entity that has thousands of stores, and you have people within those stores who are paid on the volume of transactions that are processed, I think it is natural, and I am very dubious about the fact that they would comply with that. And there has to be someone who complains in order to have the issue raised.

Mr. MATHESON. I understand your concern.

Mr. GHIGLIERI. But you do acknowledge that the way you describe it would be in violation of law, what is in your testimony?

Mr. MATHESON. I want to make sure of that.

Just one quick observation for Mr. Connelly and Mr. Ghiglieri. I have been in this job now for 6 years and 4 months and I have had Utah community bankers come and meet with me on a periodic basis. Not one has ever mentioned the ILC issue. They live in the State where ILCs are based, we have all heard that. And they have never expressed concern to me.

I am sure you can probably find somebody in your membership who has written me a letter. That may be. I am just saying, in my face-to-face meetings, they are far more concerned about issues—and I am not getting into this issue, Mr. Chairman—they are far more concerned about credit unions and whatnot than they are—

The CHAIRMAN. If the gentleman would yield, we are very glad to accommodate the gentleman. But to have left the committee and then introduce the credit union issue is certainly a violation of the norm of—

Mr. MATHESON. That is the benefit of leaving the committee, Mr. Chairman.

The CHAIRMAN. The gentleman, I assume, would like to be welcomed back?

Mr. MATHESON. I am done. And I just again want to reiterate, thank you for your generosity in letting me participate today, Mr. Frank.

The CHAIRMAN. I am just going to recognize myself for 1 minute, just to make a comment on the point we talked about, and it has to do with conflict of interest laws. And this is, in effect, the distinction between banking and commerce is a variant of a conflict of interest law.

You do not pass conflict of interest laws to prohibit bad things. You pass substantive laws to prohibit bad things. The reason for laws prohibiting conflict of interest is that you want to reduce the number of occasions in which the temptation to do those things arises, in which incentives to violate the substantive laws are magnified, and in which the difficulty of enforcing the substantive law becomes more—greater. In other words, conflict of interest laws are to prevent you from—they are anti-temptation laws; they are not anti-act laws.

Now that may or may not be right in this case, but that is the framework. So the fact that there are substantive laws that prevent things doesn't, in a number of other areas, tell us not to pass laws that diminish the incentive and opportunity for those things to happen.

I thank the panel, I thank the members, and the hearing is concluded.

[Whereupon, at 12:46 p.m., the hearing was adjourned.]

A P P E N D I X

April 25, 2007

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

H.R. 698, THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

April 25, 2007
Room 2128, Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning industrial loan companies and industrial banks (collectively, ILCs).[1]

The FDIC welcomes careful consideration by Congress of the issues regarding commercial ownership of ILCs. These issues are complex and involve key questions of public policy that are most appropriately determined by Congress. This hearing and congressional discussions regarding possible legislative actions are encouraging developments that hopefully will lead to the resolution of key ILC-related issues by the end of the year. Legislative action that clarifies the role and supervision of ILCs would be strongly welcomed and carefully implemented by the FDIC.

In July 2006, the FDIC imposed a six-month moratorium on ILC applications for deposit insurance and notices of change in control. Recently, the FDIC Board voted to extend the moratorium for an additional year for those applications for deposit insurance and change in control notices for ILCs that will become subsidiaries of companies engaged in non-financial activities, i.e., commercial activities.[2] This moratorium extension will allow the FDIC to carefully weigh the safety and soundness concerns that have been raised regarding

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[1] The terms "industrial loan company" and "industrial bank" mean any insured State bank that is an industrial bank, industrial loan company, or other similar institution that is excluded from the definition of "bank" in the Bank Holding Company Act of 1956 (BHCA) pursuant to section 2(c)(2)(H) of the BHCA, 12 U.S.C. 1841(c)(2)(H).

[2] For purposes of the extended moratorium, the term "financial activity" includes: (i) banking, managing or controlling banks or savings associations; and (ii) any activity permissible for financial holding companies under 12 U.S.C. 1843(k), any specific activity that is listed as permissible for bank holding companies under 12 U.S.C. 1843(c), as well as activities that the Federal Reserve Board (FRB) has permitted for bank holding companies under 12 CFR 225.28 and 225.86, and any activity permissible for all savings and loan holding companies under 12 U.S.C. 1467a(c). The term "non-financial activity" is any other activity. The FDIC intends to follow the guidance of the FRB and OTS in its interpretations of the term "financial activity" and to consult with the FRB and/or OTS before making any decisions.

commercially-owned ILCs. At the same time, the extension of the moratorium provides an opportunity for Congress to consider the important public policy issues regarding the ownership of ILCs by commercial companies.

Although the FDIC is not endorsing any particular legislative proposal, we are committed to providing Congress with any technical assistance necessary to assist passage of legislation that addresses the important issues regarding ILCs. My testimony will briefly discuss the history and characteristics of ILCs, and the FDIC's recent actions relative to ILCs. Finally, I will discuss possible enhancements to H.R. 698, the Industrial Bank Holding Company Act of 2007.

Background

In existence since 1910, ILCs are state-chartered insured depository institutions that are supervised by their chartering states and the FDIC. ILCs (also known as industrials, industrial banks, or thrift and loans) historically operated similar to finance companies, providing loans to wage earners who could not otherwise obtain credit. The FDIC has been involved in the supervision of ILCs since 1934 when 29 ILCs received deposit insurance coverage.

ILCs have proven to be a strong, responsible part of our nation's banking system and offered innovative approaches to banking. Many have contributed significantly to community reinvestment and development. For example, a non-profit community development corporation operates an ILC designed for the express purpose of serving the credit needs of people in East Los Angeles. Other ILCs serve customers who have not traditionally been served by other types

of financial institutions, such as truckers who need credit to buy fuel far from home. The record to date demonstrates that the overall industry has operated in a safe and sound manner, and that the FDIC has been a vigilant, responsible supervisor of that industry.

The modern evolution of ILCs began in 1982 with the passage of the Garn-St Germain Depository Institutions Act, which expanded ILCs' eligibility to apply for federal deposit insurance. In 1987, the Competitive Equality Banking Act (CEBA) excluded certain ILCs from the definition of "bank" in the Bank Holding Company Act (BHCA). As a result, any company could control an ILC without necessarily being subject to consolidated supervision under the BHCA. In order to be excluded from the BHCA, the ILC must have received a charter from one of the limited number of states issuing them and the law of the chartering state must have required federal deposit insurance as of March 5, 1987. In addition, the ILC must meet one of three conditions:[3] (1) the ILC must not accept demand deposits; (2) its total assets must be less than $100 million; or (3) control of the ILC has not been acquired by any company after August 10, 1987. A company that controls an ILC is not required to be subject to supervision by the Federal Reserve Board (FRB) and, therefore, can engage in commercial activities. While the parent companies of ILCs are not required to be supervised by the FRB or the Office of Thrift Supervision (OTS), several such companies are supervised by these agencies.

As of January 31, 2007, there were 58 insured ILCs, with 45 based in Utah and California. ILCs also operate in Colorado, Hawaii, Indiana, Minnesota and Nevada. Because the powers of the ILC charter are determined by the laws of the chartering state, the authority

[3] Bank Holding Company Act section 2(c)(2)(H), 12 U.S.C. 1841(c)(2)(H).

granted to an ILC may vary from one state to another and may be different from the authority granted to commercial banks. Over time, some of the chartering states expanded the powers of their ILCs to the extent that some ILCs now generally have the same powers as state 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, except that some states do not permit ILCs to offer demand deposit accounts regardless of institution size.

Profile

ILCs represent a relatively small share of the banking industry, accounting for less than one percent of the almost 8,700 insured depository institutions and approximately 1.8 percent of industry assets. Attachment 1 provides a list of operating ILCs with their asset and deposit data as of December 31, 2006.

At year-end 1995, total ILC assets were approximately $12 billion. Beginning in 1996, a number of financial services firms that controlled ILCs began offering their clients the option of holding their uninvested funds in insured deposits in the firms' ILCs through sweep deposit programs. Also in 1996, American Express moved its credit card operations from its Delaware credit card bank to its Utah ILC, causing a substantial increase in ILC assets. As a result of these and other developments, between year-end 1995 and year-end 2006, total ILC assets grew from approximately $12 billion to $213 billion. More than 60 percent of that growth is attributable to a small number of financial services firms (see Attachment 2).

Of the 58 existing ILCs, 43 are either widely held or controlled by a parent company whose business is primarily financial in nature. These include ILCs owned by such companies as Merrill Lynch & Co., Inc., American Express Company and Morgan Stanley. These 43 ILCs represent approximately 85 percent of the ILC industry's assets and 89 percent of the ILC industry's deposits as of December 31, 2006. The remaining 15 ILCs are associated with parent companies that may be considered non-financial in nature.

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. Four of the largest and most complex ILCs are subject to near continuous on-site supervision. 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.

The primary difference in the supervisory structures of ILCs and other insured depository institutions is the type of authority that can be exerted over a company that controls the

institution. The FRB 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 the affairs of any affiliate of an ILC, including a parent company and any of its subsidiaries, as may be necessary to disclose fully the relationship between the ILC and the affiliate, and the effect of any such relationship on the ILC. However, as a practical matter, where the parent of an ILC is supervised by the FRB or OTS, the FDIC routinely coordinates with these agencies in obtaining such information regarding affiliates. In the case of an affiliate that is regulated by the Securities and Exchange Commission (SEC) or a state insurance commissioner (functional regulators), the FDIC and the functional regulator share information.

FDIC supervisory policies regarding any depository institution, including an ILC, are concerned with organizational relationships, particularly 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 depository institution.

The FDIC's overall 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."[4] The authorities available to the FDIC to

[4] Government Accountability Office (GAO), Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, September 2005, p. 24.

supervise ILCs have proven to be adequate thus far for the size and types of ILCs that currently exist. However, the number, size and types of commercial applicants have changed significantly in recent years, causing the FDIC to carefully examine this new ILC environment.

Recent FDIC Actions Regarding ILCs

Moratorium and Request for Public Comment

On July 28, 2006, the FDIC imposed a six-month moratorium on action with respect to all ILC deposit insurance applications and change in control notices. The purpose of the moratorium was to enable the FDIC to further evaluate: (1) industry developments; (2) the various issues, facts, and arguments raised with respect to the ILC industry; (3) whether there are emerging safety and soundness issues or policy issues involving ILCs or other risks to the insurance fund; and (4) whether statutory, regulatory, or policy changes should be made in the FDIC's oversight of ILCs in order to protect the deposit insurance fund or support important congressional objectives.

Subsequently, on August 23, 2006, the FDIC published in the Federal Register a request for public comment on twelve questions regarding ILCs and their ownership.[5] The FDIC received over 12,600 comment letters in response to the Request for Public Comment during the comment period. Although the vast majority of comments were directed at specific pending applications or notices, a number of comments addressed substantive issues concerning the ILC industry and its regulation.

[5]See Industrial Loan Companies and Industrial Banks, 71 FR 49456 (August 23, 2006).

The FDIC's experience and the comments suggest that no risk or other possible harm is unique to the ILC charter. Rather, concerns about ILCs are focused on their ownership and proposed business models or plans. Consequently, the FDIC's analysis of how to proceed focused primarily on the proposed owners of ILCs. At the time that the initial moratorium expired on January 31, 2007, eight ILC deposit insurance applications and one change in bank control notice were pending before the FDIC.

The Moratorium Extension

Based on the concerns regarding ILC ownership raised during the moratorium period, the FDIC Board extended the moratorium for ILCs that would be owned or controlled, directly or indirectly, by commercial companies. The business plans for these ILCs tend to be more complex and differ substantially from the consumer lending focus of the original ILCs. In many instances, these ILCs directly support one or more affiliate's commercial activities or serve a particular lending, funding or processing function within a larger organizational structure. Under this kind of ownership model, consolidated supervision would generally not be present, raising concerns that the supervisory infrastructure may not provide sufficient safeguards to identify and avoid or control safety and soundness risks and the risks to the Deposit Insurance Fund. As a result, the FDIC determined that this class of ownership needs further study and consideration on two key issues: (1) what, if any, increased risks are created by commercial company ownership and (2) how well current supervisory models apply to such owners.

In addition, the FDIC determined that it is appropriate to provide Congress with a reasonable period to consider the developments in the ILC industry and, if necessary, to make revisions to existing statutory authority. Even though the FDIC has authority to act on any particular application, notice, or request involving an ILC, the FDIC considered the potential effect of the extended moratorium on individual applicants and proponents, including commercial companies, and believes that congressional resolution of these issues is preferable.

Consequently, the FDIC concluded that the moratorium should be extended through January 31, 2008 for ILCs that would be owned or controlled, directly or indirectly, by companies engaged in commercial activities. The extension will allow the FDIC needed time to evaluate the various issues, facts, and arguments associated with the ownership of an ILC by a commercial company, and allow Congress time to consider legislation concerning ILCs.

Under the extended moratorium, the FDIC will take no action to accept, approve, or deny any application for deposit insurance, or to accept, disapprove, or issue a letter of intent not to disapprove any change in control notice, with respect to any ILC that would become a direct or indirect subsidiary of a company engaged in commercial activities. Although commercially owned ILCs have not resulted in serious problems to date, the FDIC will continue to closely monitor existing ILCs that currently are controlled by commercial companies in light of the concerns that have been expressed.

The moratorium extension does not apply to, and the FDIC will proceed with action on, any application for deposit insurance or any change in control notice with respect to: (1) any ILC

that would become a subsidiary of a company or companies engaged only in financial activities; and (2) any ILC that would not become a subsidiary of a company.

Generally, ILCs owned by individuals do not present the same issues as ILCs owned by commercial companies. An ILC owned by individuals is not subject to the BHCA, and has no parent company or subsidiary of a parent company that could present safety and soundness risk or a conflict of interest with the ILC. ILCs that are owned by financial companies that are subject to federal consolidated bank supervision, such as bank holding companies, financial holding companies, and thrift holding companies, generally are subject to the examination, reporting, and monitoring systems of bank supervisors, which can be effective tools in preventing an affiliate's activities from causing a safety and soundness risk to the ILC. Importantly, holding companies that are expected to serve as a source of strength to their subsidiary insured depository institutions provide a resource for an insured bank in need of additional capital.[6] The FDIC believes that these classes of ILC ownership do not need further study and that the supervisory tools currently available to the FDIC are adequate.

Notice of Proposed Rulemaking -- Part 354 of the FDIC's Rules and Regulations

ILCs to be owned by financial companies not subject to federal consolidated bank supervision present some of the same issues as ILCs owned by commercial companies.

[6] The Gramm-Leach-Bliley Act of 1999 significantly limited the ability of the Federal Reserve Board to impose capital standards on functionally-regulated subsidiaries of a bank holding company. Functionally-regulated subsidiaries generally include any company that is a securities broker/dealer, an investment adviser, an investment company, an insurance company, or an entity subject to supervision by the Commodities Futures Trading Commission (CFTC). See 12 U.S.C. 1844(c). Furthermore, the FRB may not require such a company that is either a bank holding company or an affiliate of the depository institution to provide funds or other assets to the depository institution if the state insurance regulator or the SEC objects. See 12 U.S.C. 1844(g).

However, the FDIC is seeking comment on whether those issues can be controlled or minimized through existing regulatory authority. Specifically, the FDIC is proposing additional safeguards that provide adequate protections for the safety and soundness of the insured ILCs and for the protection of the Deposit Insurance Fund.

The FDIC has published a Notice of Proposed Rulemaking to enhance its supervisory tools for this class of institutions. While the Notice of Proposed Rulemaking is pending, the FDIC will consider, on a case-by-case basis, deposit insurance applications and change in control notices with respect to ILCs that would become a subsidiary of one or more companies engaged only in financial activities that are not subject to federal consolidated bank supervision by the FRB or the OTS.

Among the concerns regarding an ILC being controlled by a company or layers of companies that lack federal consolidated bank supervision are the need for the parent company to serve as a source of capital and liquidity for the subsidiary ILC, the difficulty in identifying problems or risks that may develop in the company or its subsidiaries, and controlling or preventing the extent to which these risks affect the ILC. More specifically, concerns have emerged regarding the transparency of parent companies and their subsidiaries, the extent to which a parent company will serve as a source of strength for the ILC subsidiary, and dependence of the ILC on the parent company and its subsidiaries.

The proposed regulation would establish a set of comprehensive safeguards through a set of federal standards and requirements that the FDIC can apply and enforce independent of the

state authorities.[7] The proposed rules are intended to provide the safeguards to identify and avoid or control, on a consolidated basis, the safety and soundness risks and the risks to the Deposit Insurance Fund that may result from ownership by a financial company not subject to consolidated federal bank supervision. The proposed rules will provide enhanced transparency and a system of controls proposed to address the risks presented by such ownership structures.

The conditions and requirements of the proposed regulation are not novel. In many cases financial companies, such as companies engaged in securities or mortgage lending, come under some type of supervision already and, therefore, are accustomed to some form of regulatory structure and supervision. Moreover, some of the requirements that would be imposed by these proposed rules have been imposed in the past on a case-by-case basis. For example, in the course of considering deposit insurance applications or change in control notices, the FDIC has required parent companies to execute written agreements to maintain a subsidiary bank's capital and/or liquidity at certain minimum levels. In addition, the FDIC has required that banks maintain their capital at certain levels and obtain the FDIC's prior consent before making changes to their business plans. Also, the FDIC has imposed conditions aimed at ensuring the independence of the board of directors at subsidiary ILCs.

The FDIC is not proposing any changes in its regulation or supervision of ILCs that will be directly controlled by one or more individuals. Furthermore, the FDIC is not proposing any changes in its regulation or supervision of an ILC that will become a direct or indirect subsidiary

[7] While some of the chartering states do have supervisory authority over companies that control industrial bank subsidiaries, that is not true of all of the states that charter industrial banks.

of a financial company that is subject to federal consolidated bank supervision (i.e., a bank holding company, a financial holding company, or a thrift holding company).

The proposed rules also will not apply to ILCs that are already owned by financial companies not subject to federal consolidated bank supervision. However, the FDIC will continue to exercise close supervision of these ILCs and any risks that may be created in the future from their parent companies or affiliates to ensure that these institutions continue to operate in a safe and sound manner. In addition, while the proposed rules are pending, the FDIC will consider utilizing some or all of the supervisory measures included in the proposed rules in processing deposit insurance applications and change in control notices with respect to ILCs controlled by financial companies not subject to federal consolidated bank supervision.

In publishing the proposed rules, and in extending the moratorium for one year, the FDIC is not expressing any conclusion about the propriety of control of ILCs by commercial companies. Rather, the FDIC has determined that it is appropriate to take a cautious approach designed to provide greater transparency and to limit the potential risks to ILCs and to the Deposit Insurance Fund.

H.R. 698, the Industrial Bank Holding Company Act of 2007

The FDIC strongly supports efforts to provide statutory guidance on the key issues regarding the ILC charter, especially the issue of commercial ownership. As I discussed earlier in my testimony, many of the issues surrounding ILC ownership involve important public policy

considerations that should be resolved by Congress. Although the FDIC is not endorsing any particular legislative approach to resolving ILC issues, H.R. 698, the Industrial Bank Holding Company Act of 2007 provides a workable framework for the supervision of ILCs and their holding companies.

In reviewing H.R. 698, the FDIC did not consider the issues regarding the appropriate levels of commercial activities, preferring to leave this fundamental issue to the legislative process for resolution. However, the FDIC did identify some concepts that would improve and strengthen the bill with regard to the supervision of ILC holding companies.

H.R. 698 would expressly provide the FDIC with several important supervisory authorities with respect to ILC holding companies. For example, the bill would provide the FDIC with the express authority to examine the holding company and each subsidiary of the holding company to substantially the same extent that the FRB may examine bank holding companies and their subsidiaries. Likewise it provides comparable authority to require reports and recordkeeping.

Other provisions of H.R. 698 are not comparable to the supervisory tools provided to the FRB with respect to bank holding companies. For example, the FDIC should have the same express authority as the FRB to impose consolidated capital requirements on the holding company. Capital is a critical pillar of the safety and soundness of our insured institutions, and the authority to require a certain minimum level of consolidated capital would help ensure that a holding company serves as a source of strength for the insured institution.

With the addition of authority to impose consolidated capital requirements and other authorities of the Bank Holding Company Act, H.R. 698 would provide the FDIC with supervisory powers over ILC holding companies that are comparable to the FRB's powers over bank holding companies. This improved statutory framework should provide the FDIC with the tools to effectively supervise ILC holding companies.

Conclusion

The ILC charter has proven to be a strong, responsible part of our nation's banking system. ILCs have offered innovative approaches to banking. Many have contributed significantly to community reinvestment and development. Yet, the types and number of ILC applications have evolved in recent years and these changes raise potential risks that deserve further study and important public policy issues that are most appropriately addressed by Congress.

The FDIC has the responsibility to consider applications under existing statutory criteria and make decisions. While it is appropriate to proceed cautiously, the FDIC cannot defer action on these matters indefinitely.

The current statutory exemption providing for the ILC charter is quite broad. By providing clear parameters to the scope of the charter, Congress can eliminate much of the uncertainty and controversy surrounding it. Resolving these issues will enhance the value of the

ILC charter going forward. The FDIC looks forward to working with Congress in the coming months as you work to bring these matters to closure in the coming year.

This concludes my statement. I will be happy to answer any questions that the Committee might have.

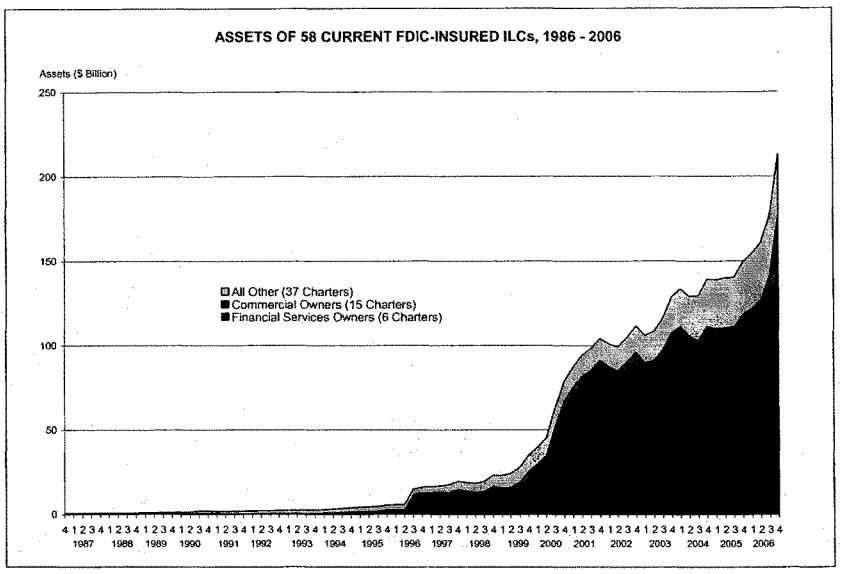
Attachment 1

Industrial Loan Companies

(Financial Data as of December 31, 2008 in $ millions)

Cert	Insured	Institution	Total Assets	Total Deposits	State	Parent
27374	10/31/1988	MERRILL LYNCH BANK USA	67,234.7	54,805.3	UT	Merrill Lynch
57565	9/15/2003	UBS BANK USA	22,009.1	19,269.6	UT	UBS AG
27471	3/20/1989	AMERICAN EXPRESS CENTURION BANK	21,096.8	4,446.2	UT	American Express
32992	5/25/1990	MORGAN STANLEY BANK	21,019.8	16,555.4	UT	Morgan Stanley
57803	8/2/2004	GMAC BANK	19,937.0	9,910.4	UT	Cerberus/GMAC
25653	9/24/1984	FREMONT INVESTMENT & LOAN	12,915.1	10,089.5	CA	Fremont General Corporation
57485	7/6/2004	GOLDMAN SACHS BANK USA	12,648.9	11,019.6	UT	Goldman Sachs
34351	9/27/1996	USAA SAVINGS BANK	5,825.6	314.2	NV	USAA Life Company
57529	4/1/2003	CAPMARK BANK	3,773.9	2,880.3	UT	Capmark Financial Group / GMAC
58009	8/24/2005	LEHMAN BRO. COMMERCIAL BANK	3,224.7	2,633.5	UT	Lehman Brothers Holdings Inc.
35575	10/20/2000	CIT BANK	2,829.5	2,312.1	UT	CIT Group
35141	11/12/1999	BMW BANK OF NORTH AMERICA	2,219.8	1,591.0	UT	BMW Group
33778	2/12/1993	GE CAPITAL FINANCIAL INC	1,991.8	218.3	UT	GE (General Electric)
33535	12/16/1991	ADVANTA BANK CORP	1,958.2	1,374.3	UT	Advanta
57833	8/2/2004	BEAL SAVINGS BANK	1,916.2	81.6	NV	Beal Financial Corporation
25667	10/5/1984	FIRESIDE BANK	1,382.4	1,162.7	CA	Unitrin, Inc.
34519	9/22/1997	MERRICK BANK	1,032.4	813.3	UT	CardWorks, LP
34697	6/1/1998	WRIGHT EXPRESS FINL SERVICES	815.6	622.0	UT	Wright Express
32707	11/3/1989	CENTENNIAL BANK	761.8	621.5	CA	Land America Financial Group
25158	6/4/1984	FINANCE FACTORS, LTD	672.9	487.4	HI	Finance Enterprises
57225	1/10/2002	VOLKSWAGEN BANK USA	665.3	488.4	UT	Volkswagen
34599	1/16/1998	PITNEY BOWES BANK INC	644.0	516.6	UT	Pitney Bowes
33493	8/29/1991	TAMALPAIS BANK	501.8	369.8	CA	Epic Bancorporation
34781	10/1/1998	TRANSPORTATION ALLIANCE BK	483.2	406.8	UT	Flying J, Inc.
58001	9/29/2005	MAGNET BANK	458.7	406.3	UT	No affiliation
58177	11/28/2005	SALLIE MAE BANK	438.9	293.3	UT	Sallie Mae
35260	11/12/1999	REPUBLIC BANK INC	437.5	378.3	UT	No affiliation
57408	7/21/2003	EXANTE BANK	391.3	295.7	UT	UnitedHealth Group
26363	9/10/1985	COMMUNITY COMMERCE BANK	343.3	227.0	CA	TELACU
27330	8/26/1988	SILVERGATE BANK	336.4	207.0	CA	Silvergate Capital
57449	12/22/2003	MEDALLION BANK	309.5	258.3	UT	Medallion Financial
34820	4/3/2000	SECURITY SAVINGS BANK	278.8	172.2	NV	Stampede Capital LLC
32743	1/22/1990	CIRCLE BANK	204.3	131.0	CA	New West Bancshares
57570	12/1/2003	WORLD FINANCIAL CAPITAL BANK	193.4	123.9	UT	Alliance Data Systems
57542	8/16/2004	TOYOTA FINANCIAL SAVINGS BANK	175.6	27.6	NV	Toyota
26704	7/3/1986	BALBOA THRIFT & LOAN ASSN	173.4	155.5	CA	Hafif Bancorporation
91005	11/5/1985	5 STAR BANK	165.7	130.6	CO	Armed Forces Benefit Association
26271	6/3/1985	HOME BANK OF CALIFORNIA	164.6	110.6	CA	La Jolla Savers and Mortgage Fund
90017	7/21/1987	FIRST FINANCIAL BANK	148.0	31.2	CO	First Data Corp.
57293	6/3/2002	ENERBANK	147.3	126.2	UT	CMS Energy
27539	6/28/1989	FIRST SECURITY THRIFT CO	140.7	78.8	CA	First American Corp
26615	2/25/1986	GOLDEN SECURITY BANK	134.0	109.2	CA	No affiliation
25870	12/17/1984	FINANCE & THRIFT CO	119.0	95.6	CA	F&T Financial Services, Inc.
25803	12/17/1984	RANCHO SANTA FE TH & L ASSN	99.1	69.1	CA	Semperverde Holding Company
57056	3/1/2001	CELTIC BANK	95.5	77.6	UT	Celtic Investment, Inc.
32908	2/16/1990	TUSTIN COMMUNITY BANK	56.4	45.9	CA	No affiliation
32907	3/23/1990	THE MORRIS PLAN COMPANY	55.4	41.5	IN	First Financial Corporation
90040	9/28/1987	HOME LOAN INDUSTRIAL BANK	53.9	43.2	CO	Home Loan Investment Company
57962	8/1/2005	ALLEGIANCE DIRECT BANK	38.3	30.6	UT	Leavitt Group Enterprises, Inc.
35228	11/3/1999	ESCROW BANK USA	34.9	1.0	UT	Capmark Financial Group / GMAC
26755	8/7/1986	MINNESOTA 1ST CREDIT & SVG INC	25.6	18.8	MN	Minnesota Thrift Company
34313	8/25/1997	EAGLEMARK SAVINGS BANK	24.5	1.5	NV	Harley-Davidson
58148	1/26/2006	LCA BANK CORPORATION	18.5	13.1	UT	Lease Corporation of America
34404	5/15/1997	WEBBANK	15.9	7.6	UT	Steel Partners II, LP
35533	10/5/2000	FIRST ELECTRONIC BANK	14.2	8.2	UT	Fry's Electronics
57769	9/27/2004	TARGET BANK	14.2	8.4	UT	Target Corporation
34549	9/22/1997	AMERICAN SAVINGS INC	3.9	1.8	MN	Waseca Bancshares
35400	1/12/2001	TRUST INDUSTRIAL BANK	2.7	0.6	CO	FISERV

Attachment 2



TESTIMONY
OF

ROBERT COLBY, DEPUTY DIRECTOR
DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE CONSOLIDATED SUPERVISION OF
U.S. SECURITIES FIRMS AND
AFFILIATED INDUSTRIAL LOAN CORPORATIONS

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

APRIL 25, 2007

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony of Robert Colby, Deputy Director

Division of Market Regulation, U.S. Securities and Exchange Commission

CONCERNING THE CONSOLIDATED SUPERVISION OF U.S. SECURITIES FIRMS AND AFFILIATED INDUSTRIAL LOAN CORPORATIONS

Before the Financial Services Committee

U.S. House of Representatives

April 25, 2007

Chairman Frank, Representative Bachus and members of the Committee, I am very pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for supervising U.S. securities firms on a consolidated basis. I look forward to explaining how this system of supervision provides protection to all regulated entities in the consolidated group, including the Industrial Loan Companies that are the topic of this morning's hearing. And I appreciate the discussions we have had with Chairman Frank and the staff about possible amendments to H.R. 698, the bill under consideration this morning, that would avoid subjecting U.S. securities firms already supervised by the Commission under a comprehensive and effective program, to a second and duplicative consolidated supervision regime.

The Commission currently supervises five of the major U. S. securities firms on a consolidated, or group-wide, basis: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. For such firms, referred to as consolidated

supervised entities or "CSEs", the Commission oversees not only the US registered broker-dealer, but also the holding company and all affiliates on a consolidated basis. These affiliates also include other regulated entities, such as foreign-registered broker-dealers and banks, as well as unregulated entities such as derivatives dealers. Four of the firms, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley own ILCs that account for 1.0%, 0.6%, 7.2% and 1.2% of consolidated assets, respectively. Three of the firms, Lehman Brothers, Merrill Lynch and Morgan Stanley also own thrifts that account for 3.3%, 1.7% and 0% of the consolidated assets of each firm respectively.

The CSE program provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. This prudential regime is crafted to allow the Commission to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including US and foreign-registered banks and broker-dealers, or the broader financial system at risk. When a CSE firm has a regulated entity in the consolidated group that is subject to oversight by another functional regulator, the Commission defers to that functional regulator as the supervisor of the regulated affiliate. We also share relevant information concerning the holding company with our fellow regulators, both domestically and internationally. Indeed the Commission's CSE program has been recognized as "equivalent" to that of other internationally recognized supervisors, including the U. S. Federal Reserve, for purposes of the European Union's Financial Conglomerates Directive.

While maintaining broad consistency with Federal Reserve holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflects the reliance of securities firms on mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity in all market environments for holding companies that do not have access to an external liquidity provider.

Before I describe the CSE program in detail, I will provide some historical perspective. Over the past twenty years, the Commission, in its role as the functional regulator of US broker-dealers, became increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or an affiliate. This risk, as broker-dealers have become affiliated with more and more complex holding company structures, was exemplified by the bankruptcy of the Drexel Burnham Lambert Group and the consequent liquidation of its broker-dealer affiliate in 1990. Post-Drexel, the Commission and its staff undertook a number of initiatives to conduct group-wide risk assessments of financial institutions with significant broker-dealer subsidiaries. The initiatives included (1) Commission risk assessment rulemaking using authority granted by the Market Reform Act of 1990 requiring larger broker-dealers to provide certain information about material affiliates, (2) creation of the Derivatives Policy Group consisting of firms active in OTC derivatives that agreed to voluntarily provide information to Commission staff about their OTC derivatives activities, and (3) the Commission's program for supervision of broker-dealers that register as OTC derivatives dealers. These initiatives assisted the Commission in understanding how financial

institutions with large broker-dealer subsidiaries manage risk globally at the group-wide level, and have over time allowed the Commission to develop a unique capacity to regulate securities firms.

Motivated in part by the need for group-wide risk monitoring, and in part by requirements of the European Union's Financial Conglomerates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis, the Commission in 2004 crafted a new comprehensive consolidated supervision regime that was intended to protect all regulated entities within a group including broker-dealers. The rule was designed to restrict eligibility to those groups with a large and well-capitalized broker-dealer. In other words, the Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies affiliated with a broker-dealer incidental to its primary business activity. As a result, the rule effectively requires that the principal broker-dealer have tentative net capital, measured as equity plus subordinated debt less illiquid assets, of at least $5 billion.

The CSE program has five principal components: First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission examines the implementation of these controls. Third, CSEs are also monitored continuously for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to

maintain significant pools of liquidity at the holding company, where these are available for use in any regulated or unregulated entity within the group without regulatory restriction.

Before I expand on each of these in turn, I would like to point out that these five principal program components are implemented in conjunction with the authority to protect regulated entities within the groups. When potential weaknesses are identified, the Commission has broad discretion under our rules to respond, for example by mandating changes to a firm's risk management policies and procedures, by effectively requiring an increase in the amount of regulatory capital maintained at the holding company, or by requiring an expansion of the pool of highly liquid assets held at the parent. These powers are not theoretical abstractions. All three of the steps that I just cited, namely requiring changes to risk management systems, requiring more capital, and requiring more liquidity have been taken at various firms over the past two years.

1. The requirement to maintain and document a system of risk controls, including measures to manage the market, credit, liquidity, legal, and operational risks associated with a CSEs business activities, is vested in Exchange Act Rule 15c3-4, by which CSEs must abide. Review by the staff, and ultimate approval by the Commission, of this system of risk controls is a critical part of the process by which each of the five investment bank holding companies became a CSE. While in many respects the system of controls present at the CSE firm bears a strong similarity to analogous systems at other large, complex and internationally active financial institutions, they do reflect the importance to securities firms of daily mark-to-market of most positions as a risk management and risk governance tool. Establishing effective controls around the mark

process, particularly where less liquid or more complex products are concerned, is a major focus both of the firm's risk management and financial control functions, and of the Commission's supervision program.

2. Subsequent to approval, the Commission conducts periodic examinations of the CSE's risk and financial controls. These examinations are intended to test whether the documented policies and procedures, particularly concerning the marking of positions to market, are implemented in a consistent and robust fashion. Examinations are focused on the holding company and its unregulated affiliates. Banking affiliates, including ILCs, already subject to supervision by a federal financial regulator are not subject to Commission examination.

3. The CSE supervisory regime is designed to leverage the work of the control functions within the firms. To monitor the financial and operational condition of the holding company, and to verify that the risk control system is functioning effectively, a multi-disciplinary team of Commission staff, including economists, financial engineers, and accountants, meet regularly with senior risk managers, financial controllers, treasury personnel, and internal auditors of the CSEs. A key theme throughout these discussions is risk concentration, and how the control functions collectively manage concentrated exposures of various types.

Commission staff meets monthly with senior market and credit risk managers of the CSEs charged with managing a bidirectional flow of risk information between the trading businesses which take market and credit risk, and the senior management. In one direction, value-at-risk and other techniques are used to aggregate exposures across diverse businesses with different underlying risk factors both for internal risk

management and regulatory capital computations. In the other direction, a granular system of limits articulates to each business or desk the risk appetite of senior management. During the monthly meetings, the performance of the models and aggregation tools are assessed, by comparing ex ante measures of risk with ex post realizations of gain and loss. The monthly discussion is structured around a review of risk reporting and analytics prepared for the internal use of the firm's management.

On a quarterly basis, Commission staff meets with CSE treasury personnel at each firm. The focus of the discussion is the liquidity position of the holding company and, in particular, the amount and nature of liquid assets that are held at the parent, and thus available for use anywhere within the group. Of equal importance, however, are the less liquid assets held by the firm. The CSE firms use a liquidity scenario, approved by the Commission, which is intended to capture the effects of a prolonged market stress event to calibrate liquidity requirements, which includes retirement of outstanding short-term debt and additional funding requirements reflecting a presumed deterioration in the ability to fund less liquid assets through repo and repo-like transactions. During the quarterly discussion, material changes in the liquidity requirements generated by this analysis are discussed.

Quarterly meetings are also held with the CSE financial controllers to review the financial results including significant profit or losses at the desk level. Financial results are also compared with the risk exposures theoretically associated with those gains or losses as a means of validating that the risk measurement systems are functioning properly. The results of the firm's internal price testing processes, intended to validate the marking-to-market of complex and illiquid products, are also reviewed.

Also on a quarterly basis, Commission staff meets with CSE internal auditors to cover significant audit findings and the evolution of the audit plan throughout the year. The resolution of findings, or their escalation to the firm's audit committee, is tracked. Selected audit reports, particularly those related to risk governance, are discussed in detail with the audit staff.

4. The on-site work described above is augmented by the Commission staff's review of monthly holding company capital adequacy measures, which are required under the CSE rule to be computed in a manner consistent with the Basel Standard. While not required by the rule, all of the firms are applying Basel II and its advanced approach to credit risk exposure. Each CSE has undertaken to maintain a ratio of regulatory capital to risk-weighted assets of at least 10 percent, the Federal Reserve's standard for a well-capitalized institution.

5. The final component of the program is a liquidity pool that each CSE is required to maintain at the parent level. In addition to the Basel capital calculation required of CSE firms, the Commission also requires CSE firms to meet certain liquidity standards. Securities firms rely on a wide range of funding sources, notably repo and repo-like secured financing of assets. In the face of any crisis – whether real or only perceived – secured lenders are likely to require significantly more collateral while unsecured lenders may disappear altogether. CSE firms must conscientiously manage this liquidity risk using their own resources. There are a number of instances where securities firms that were adequately capitalized by the measures of the day collapsed because the asset side of the balance sheet proved insufficiently liquid to withstand a stress event. Thus, under the CSE program, the Commission looks not just at capital

adequacy, but also at the liquidity of the assets being supported by that capital through an additional set of standards. Generally, each CSE firm must have sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year. To meet these standards, each CSE firm holds a substantial amount of liquid assets that are available to the ultimate holding company and its subsidiaries to deal with a crisis or perceived crises anywhere within the organization. Again consistent with the Commission's authority under the rule, each CSE has undertaken to maintain a liquidity pool of specified size.

I have described this morning a system of consolidated supervision that I believe effectively achieves the goal of reducing the likelihood that weakness within the holding company or an unregulated affiliate will place a regulated entity, including an ILC, or the broader financial system, at risk. I have described the means by which we monitor on an ongoing basis the financial and operational condition of the CSE holding companies, leveraging our many years of experience in overseeing broker-dealers and their affiliated holding companies. And I have described our broad authority under the CSE rules to take action in the event of a weakness or potential weakness. Further, while the program is similar to other consolidated supervision regimes, notably the Federal Reserve's oversight of Bank Holding Companies, the CSE regime is tailored to reflect the reliance of securities firms on mark-to-market accounting as a critical risk and governance control, as well as the need for such firms to maintain adequate internal liquidity sources to withstand market stress events. Finally, the CSE program is recognized internationally as providing consolidated supervisory oversight of our largest U.S. securities firms that is equivalent to that of well recognized federal banking regulators.

In conclusion, while we generally support the goals of the H.R. 698, the bill as introduced would subject the CSEs that already are highly regulated under the Commission's consolidated supervision program to an additional layer of duplicative and burdensome holding company oversight. The bill should be amended to recognize the unique ability of the Commission to comprehensively supervise the consolidated groups that are overwhelmingly in the securities business, especially given the heightened focus on these issues in an era of increased global competitiveness. Because the Commission has established a successful consolidated supervision program based on its unique expertise in overseeing the securities businesses, the Commission's program should be carved out of this legislation in the same way as are the holding companies supervised by the Federal Reserve and OTS.

Thank you again for the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

Written Testimony of

America's Community Bankers

on

"H.R. 698, the Industrial Bank Holding Company Act of 2007"

before the

Committee on Financial Services

of the

U.S. House of Representatives

on

April 25, 2007

Arthur R. Connelly
First Vice Chairman
America's Community Bankers

Chairman and CEO
South Shore Bancorp MHC
Weymouth, Massachusetts

Chairman Frank, Ranking Member Bachus and members of the Committee, thank you for inviting me to testify before you today on the Industrial Bank Holding Company Act of 2007. My name is Arthur Connelly. I am the Chairman and CEO of South Shore Bancorp MHC, a $915 million institution in Weymouth, Massachusetts. I am also proud to serve as First Vice Chairman of America's Community Bankers (ACB), and I am here today to testify on their behalf. The appropriate regulatory structure for industrial loan companies (ILCs) is incredibly important, and I think that it is both appropriate and necessary for Congress to address the issue.

Let me start off by saying clearly and unequivocally that ACB supports H.R. 698, the "Industrial Bank Holding Company Act of 2007." I want to also make clear that ACB believes the recent withdrawal by Wal-Mart of its ILC application does not end the need for this legislation. There are still eight commercially owned ILC applications pending at the FDIC. As I will detail in my testimony below, we believe that this legislation improves the regulation of ILCs and creates regulatory parity within the banking industry by building a stronger barrier between banking and commerce, and ensuring holding company supervision for ILCs that currently do not have it. The legislation does not punish those commercial companies that have legally obtained an ILC charter by forcing them to divest the bank. This is a fair precedent that follows the model established for unitary thrifts in the Gramm-Leach-Bliley Act (GLBA). The legislation also conforms with one of ACB's key principles, charter choice. ACB believes that the diversity of banking charters in the United States, and the ability of institutions to choose between them, provides strength and flexibility to the banking system. ILCs are an important part of charter choice in the United States. Unfortunately, the current regulatory structure provides the ILC charter with no consolidated regulation and the ability to be owned by commercial firms, structures that Congress wisely prohibited for other bank charters. This also creates an uneven playing field within the banking industry.

Background

Throughout the 20th Century the U.S. Congress has worked to strengthen the separation of banking and commerce. The Congress first established this separation in the Glass-Steagall Act, and then reinforced it throughout the 20th Century in such bills as the Bank Holding Company (BHC) Act of 1956, the Competitive Equality Banking Act (CEBA), and finally the GLBA. Each of these laws closed a channel by which non-financial companies could own a bank or enter into the banking business. Congress and our nation's banking officials witnessed the events preceding the Great Depression, the Japanese economic crisis and the 1998 Southeast Asian economic crisis. A major component precipitating these crises was banks without adequate supervision and under the influence of commercial firms with conflicts of interest. One clear example is the problems experienced at keiretsu banks in Japan during the 1990's. Because of cozy corporate relationships these banks became saddled with so many bad loans that the banks were virtually non-viable and needed a government bailout. The drag on the Japanese economy from the banking crisis lasted over a decade.

The risks presented by commercial ownership are substantial. First and foremost, when a commercial entity owns a bank it can create a conflict of interest. A bank's normal process of underwriting loans for their appropriate risk could be subjected to pressures by the commercial parent to make risky or unwise loans to affiliated companies or customers of the commercial

entity. The lack of consolidated holding company regulation at commercially owned ILCs makes this problem harder to supervise. These pressures introduce tremendous risk into the deposit insurance system. An example of these risks is the proposed business model for the Home Depot ILC. The company proposes to provide loans to customers who use Home Depot contractors for remodeling. That opens the door to possible business tying arrangements, which are designed to lessen competition and are generally prohibited in the United States. Lending decisions could be made not on the merits of the loan, but rather on the business relationship of the borrower. We believe that such tying is wrong and inconsistent with the tenets of free market banking.

These risks, combined with the rapid growth of ILCs, create systemic risk concerns. We recognize that to date ILCs have operated in a safe and sound manner. ILCs have not suffered losses or cost the insurance fund money. However, Congress cannot make policies based on the recent success of ILCs during a time of historically low bank losses. We believe that Congress must set a framework for banking policy that will ensure continued safety and soundness in the banking system going forward.

The concerns expressed above are not meant as a criticism of the regulatory effectiveness of the FDIC or the Utah Banking Commissioner. Both have proven to be exceptional regulators, and to date have done an admirable job of providing sound regulation for the nation's ILCs. Unfortunately, right now the FDIC does not have the statutory authority it needs to act as a holding company regulator for ILCs. The Federal Reserve and Office of Thrift Supervision (OTS) both have the authority to examine the activities and operations of bank and thrift holding companies to ensure that they do not pose a risk to the financial system. The FDIC only has the direct authority to look at the depository itself and the relationship between the institution and its affiliated companies. While the FDIC has made great efforts to supplement its authority through agreements with the institutions it insures, as the GAO has pointed out, these agreements have yet to be tested in times of significant economic distress. Given the rapid growth in insured deposits at ILCs, the lack of holding company oversight for every company is troubling. Currently, a majority of ILC deposits are in institutions regulated as thrift holding companies, meaning that the OTS is exercising holding company authority over the parent. This has ensured safe and sound operation of many ILCs. However, there are pending applications for ILCs from large retail chains that would fall outside the holding company authority of the OTS or Federal Reserve. These companies could establish large, fast growing, retail operations that could threaten the insurance fund.

That growth, with lack of proper supervision, is an important reason why ACB believes that legislation is necessary. An additional issue of concern to community banks is the inequity created by the current regulatory structure for ILCs. Community banks are not afraid of competition. Rather, we think that competition is healthy, and provides consumers with the best services at the best prices. However, we are concerned about competition that is unbalanced and unfair. If the current regulatory structure for ILCs remains, retail companies such as Target would be able to establish retail banking operations and compete with existing banks on an uneven playing field. The regulatory structure for ILCs is less rigorous and demanding than for other banks. That regulatory inequality would give ILCs a decided advantage in head-to-head

competition. Retailers with an ILC charter would be able to use their size and reach to capture banking customers and potentially devastate community banking in this country.

In addition, ILCs raise questions about conflicts when they process payment system transactions for their parent company. The role of the acquiring bank under current card network rules is to ensure that the merchant (in this case the ILC's parent company) meets merchant qualifications. A good example of this is payment card industry data security requirements. Recent data security breaches at large retailers, such as the TJX Companies, Inc., illustrate the importance of independent enforcement of these standards. With an ILC and its commercial parent on both sides of these transactions, there would be a conflict of interest that could place the consumer at risk. Further, it would be challenging, and potentially impossible, to ensure that there would be effective firewalls against financial problems in the commercial store spreading to the ILC. In such a scenario, the risk of disruption stemming from financial problems at commercial entities would be great. In large companies with a high number of transactions and large dollar volumes, the need for the acquirer and merchant to be independent and free of influence from each other is clear.

I want to take a minute to applaud Wal-Mart for withdrawing their ILC application. Currently, Wal-Mart is able to provide banking services within their stores through agreements with community banks. This has provided a mutually beneficial arrangement that allows Wal-Mart to make available convenient banking services to its customers, while providing banks access to a broad customer base. Hopefully this successful relationship will continue, because it provides for banking services by well regulated depository institutions, while providing convenience for consumers. Over 300 banks offer services at over 1,200 Wal-Mart branches, including a number of ACB members, and we hope to see that number grow. However, the withdrawal of the Wal-Mart ILC application does not change the regulatory concerns that ACB has with certain ILC charters.

H.R. 698

ACB believes that H.R. 698 provides a fair and balanced manner in which to ensure the safety and soundness of the banking system going forward, while not punishing those who have followed the law to date. The legislation does two principal things:

1) Creates an ILC holding company structure for ILCs not currently in a bank holding company or thrift holding company structure. The new ILC holding company would be regulated by the FDIC.
2) Prohibits commercial ownership of ILCs by non-financial companies. Financial companies are defined using a test similar to GLBA, where a company is defined as predominantly financial if at least 85 percent of its revenue comes from financial services. Existing commercially owned ILCs are grandfathered.

We believe that, when examining H.R. 698, it is helpful to look at the most recent legislative action by Congress on the issue of commercial ownership of banks. Prior to 1999, commercial firms were allowed to own unitary thrifts. In the GLBA, Congress prohibited any future ownership of unitary thrifts by commercial companies. However, in order to attempt to be fair to

those companies that had legally owned unitary thrifts prior to 1999, Congress grandfathered all current commercially owned unitary thrifts. In addition, GBLA defines a company as predominately financial if no more than 15 percent of its revenues derive from commercial businesses. These two provisions in combination appear to form the model for the Industrial Bank Holding Company Act, and we believe it is a fair one.

For the reasons I will outline below, we believe that H.R. 698 will ensure the future stability and safety of our nation's banking system without being punitive to existing ILCs. It achieves this goal by following the successful model created in the GLBA. First, creating an FDIC regulated ILC holding company is both necessary and appropriate. As I said above, the lack of holding company oversight for commercially owned ILCs is troubling and adds unnecessary risk to the banking system. Providing the FDIC with the authority to supervise not just the ILC itself, but also its parent on a consolidated basis, will allow it to ensure the safety and soundness of the institution. We also appreciate that the legislation attempts to minimize the reporting burdens by allowing the FDIC, as it deems appropriate, to utilize existing reports that ILCs submit to other agencies to fulfill an ILC's holding company reporting requirements.

In addition, we applaud the committee for recognizing that many ILCs are already part of an existing holding company structure. H.R. 698 exempts from FDIC holding company oversight those ILCs already in a BHC with supervision by the Federal Reserve, or in a thrift holding company supervised by the OTS. Currently roughly 70 percent of ILC assets are in thrift holding companies.

The legislation also utilizes a grandfathering system similar to the one applied to unitary thrift companies in GLBA. The bill has a two tier grandfathering system. ILCs chartered prior to October 1, 2003 will be exempt from the limitations placed on commercial ownership. As long as there is no change in control of the ILC, the commercial owner will be able to operate as a normal ILC. Institutions chartered between October 1, 2003 and January 29, 2007 will be able to retain ownership, but the activities of those ILCs will be limited to the activities they were engaged in on January 28, 2007. Considering that a large number of the non-financial ILC applications were approved after 2003, the restrictions in the bill are common sense. The grandfather restrictions in H.R. 698 do not punish companies that have legally obtained an ILC charter; however, they protect the safety and soundness of the banking system by ensuring that commercially-owned ILCs do not enter full service retail banking. We believe that this is a common sense and fair tradeoff.

Conclusion

In conclusion, ACB appreciates the opportunity to testify before the Committee today. We support H.R. 698 and we stand ready to help you pass this legislation. Passing the Industrial Bank Holding Company Act will close the final loophole in U.S. banking law that allows commercial ownership of a bank. This is the right policy for both the safety and soundness of the U.S. financial system, as well as for ensuring regulatory parity among the various banking charters.

HOUSE COMMITTEE ON FINANICAL SERVICES

HEARING ON:

THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

WEDNESDAY, APRIL 25, 2007

WRITTEN TESTIMONY OF JOHN L. DOUGLAS

ON BEHALF OF

THE AMERICAN FINANCIAL SERVICES ASSOCIATION

HOUSE COMMITTEE ON FINANICAL SERVICES

HB 698 – The Industrial Bank Holding Company Act of 2007
Wednesday April 25, 2007

WRITTEN TESTIMONY OF JOHN L. DOUGLAS

I appreciate the opportunity of providing testimony on this important bill. By way of background, I am a partner in the law firm of Alston & Bird and 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 nations' 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 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 mitigate the consequences of the 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. 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.

The Industrial Bank Holding Company Act of 2007 attempts to wrap itself in the cloak of protecting the public from some great danger that will result if commercial companies are allowed to own depository institutions. This bill, however, is fundamentally flawed.

First, at its heart, the legislation is anti-competitive. It allows certain companies to innovate with the delivery of financial services and products to the public, but denies that right to others. It permits some companies to assess the needs of their customers and address them proactively and directly, but precludes others from doing so. As a nation we have benefited greatly from the innovation that comes with competition; this bill would represent a step back. Parenthetically, it also excludes from the banking system important sources of capital and managerial talent. It wasn't that long ago that both were sorely lacking in our banking system, and the capital and strength provided by commercial and industrial owners was crucial.

Second, it presumes that the FDIC somehow lacks the power and authority to protect our banking system since it lacks the "comprehensive supervision" authority granted to the Federal Reserve over bank holding companies. Implicit in this presumption is that there is a looming safety and soundness issue associated with the regulatory framework governing industrial banks and their owners. There is no factual basis for this presumption.

Third, it assumes that the mixing of banking and commerce is a new development in our country that poses an extreme threat to our banking system. It ignores the history of banking in the United States, where such affiliations have always existed, and certainly ignores the modern history of banking regulation where Congress has explicitly blessed affiliations between banking and commercial firms. [1]

Finally, it attempts to distinguish between "good" owners of industrial banks (the financial firms) and "bad" owners of industrial banks (the commercial firms), without any evidence whatsoever that one poses a greater threat than the other.

I wish to devote my remarks to the second point – that the commercial ownership of industrial banks poses a threat to our system due to the lack of comprehensive supervision. I make four major points in response:

- First, industrial 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;[2] Regulation O, governing loans to officers, directors or their related interests;[3] capital requirements;[4] the Prompt Corrective Action

[1] As to the "historic" separation of banking and commerce, I will merely note that it wasn't until 1956 that activity restrictions were place 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 whether the industrial bank represents an "unintended loophole," as many have suggested, Congress has extensively considered industrial 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.
[2] 12 U.S.C. 371c, and 371c-1.
[3] 12 C.F.R. 215. See 12 U.S.C. 1817(k)(3).
[4] 12 C.F.R. 325.

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;[5] and all of the other laws, rules and regulations that promote safe and sound banking in this country. It is important to note that the Industrial Bank Holding Company Act does not change this framework in any respect.

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,[6] 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. It was our clear intention to give the FDIC and the other bank regulators all of the enforcement powers they needed to protect the banking system. Importantly, all of these enforcement powers apply with full force to an industrial bank, as well as to any officer, director, controlling shareholder or "any other person that participates in the conduct of the affairs of the institution."[7] There is no question that to the extent that either the corporate owner of an industrial bank or any affiliate of that owner engages in any violation of law, rule or regulation applicable to the industrial bank, or has engaged, is engaging or is about to engage in an unsafe or unsound practice relating to the industrial 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,[8] but also requiring that the condition be remedied and restitution made.[9] Civil money penalties up to one million dollars per day can be imposed,[10] and individuals can be removed from their positions and precluded from having any involvement not only with the industrial bank but with *any* insured depository institution.[11] The FDIC can also restrict the activities of the industrial bank or any affiliate participating in its affairs, can withdraw the deposit insurance of the industrial bank[12] and take any other action it "deems appropriate" in the event of a violation of law, rule or regulation, including forcing the divestiture of the industrial bank by its owner.[13] The Industrial Bank Holding Company Act gives the FDIC no

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[5] 12 U.S.C. 1831o. See also 12 C.F.R. 325, Part B.

[6] The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 103 Stat. 183 (Aug. 9, 1989), extensively revising 12 U.S.C. 1818.

[7] See 12 U.S.C. 1813(u) (definition of "institution-affiliated party") and 12 U.S.C. 1818.

[8] 12 U.S.C. 1818(b), (c).

[9] 12 U.S.C. 1818(b)(6).

[10] 12 U.S.C. 1818(i).

[11] 12 U.S.C. 1818(e).

[12] 12 U.S.C. 1818(a).

[13] 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 the insured depository institution or any institution-affiliated party." 12 U.S.C. 1818(b)(7). It also has the power to prohibit any "institution-affiliated party" from participating in the affairs of any financial institution under certain circumstances. Finally, the FDIC has been granted "all

power that it does not already possess over companies owning industrial banks and their affiliates.

· Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully functioning board of directors designed to assure that the industrial bank stands on its own and is not merely an arm of its corporate owner. The industrial 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 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 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. Again, the Industrial Bank Holding Company Act grants the FDIC no power that it does not already possess.

· Finally, the experience of the FDIC with respect to industrial 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 banks owned by holding companies.[14] These holding companies were not commercial enterprises, they were solely engaged in financial activities. 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 operating in holding company structures, many of which cost the FDIC billions of dollars. The list is long and sobering – Continental Illinois, First Republic, First City, MCorp, Bank of New England, and so on – many of which were subject to the much-vaunted "consolidated supervision" by the Federal Reserve as the

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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 bank and its parent were the relationship between the two create an unsafe or unsound condition.

[14] The two institutions were Pacific Thrift and Loan (see http://www.fdic.gov/news/news/press/1999/pr9971.html) and Southern Pacific Bank (see http://www.fdic.gov/news/news/press/2003/pr1103.html). There were a series of small industrial 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." See FDIC "Supervisory Insights, The FDIC's Regulation of Industrial Loan Companies: A Historical Perspective," http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html.

holding company regulator that is offered as a cure for something that hasn't proven to be a problem.[15]

I contrast the foregoing examples with the FDIC's experience with Conseco's banks in late 2002. Conseco owned a South Dakota credit card bank as well as a Utah-chartered industrial 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.[16] 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 banks are not subject to the same degree of consolidated supervision that bank holding companies must endure,[17] 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.

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[18] or solely in financial activities as deemed permissible by the Federal Reserve.[19]

It may be useful to review a statement made by Lawrence White, now a professor at NYU and a former member of the Federal Home Loan Bank Board during the thrift crisis period of the late 1980's. In discussing the crisis, he noted the issues associated with diversified ownership of thrifts. Importantly, he observed the following: "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."[20]

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[15] The point is not that the FDIC is a better regulator than the Federal Reserve; rather, it is that there is no evidence that "consolidated supervision" (i.e., the holding company oversight provided by the Federal Reserve) is a panacea for bank failures.

[16] The Conseco 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 http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html. The FDIC's experience with Tyco's industrial bank was similar. Tyco's industrial bank survived the highly publicized problems of Tyco, thanks in great part to the supervision and oversight provided by the FDIC and the state regulator.

[17] Report 05-625, United States Government Accountability Office, Report to the Honorable James A. Leach, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority, September 2005, found at http://www.gao.gov/new.items/d05621.pdf.

[18] 12 U.S.C. 1843(c)(8), the provision that primarily defines the permissible direct and direct activities of bank holding companies.

[19] 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.

[20] L. White, *The S&L Debacle, Public Policy Lessons for Bank and Thrift Regulation* (New York, Oxford University Press, 1991) 242.

The supposed "ills" that would result from the continued use of industrial banks to deliver financial services are mere shibboleths. Critics assert that an industrial 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:

- Existing laws preclude use of the industrial bank to provide any favorable accommodation to the commercial affiliate. Using an industrial 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 or entity. 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 Banc of America Securities 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 banks located in small communities 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.[21]

- Finally, if we were really concerned about the potential dangers of mixing banking and commerce, we should roll back the merchant banking powers recently granted banking organizations,[22] eliminate the FDIC's power to approve commercial activities for banks[23] and perhaps even strip commercial lending powers from banks, as there are few relationships giving a bank more power over,

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[21] 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.

[22] 12 U.S.C. 1843(k)(4)(H).

[23] 12 U.S.C. 1831a, as implemented by 12 C.F.R. 362. 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 characteristics and purchase and hold a variety of equity securities. See generally http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html.

and a greater interest in, a commercial enterprise than to be the primary source of its funding.

Further to this last point. The unfairness of this bill is evidenced by one example. It is permissible under current law for any one of a number of banking organizations to use their powers granted under Gramm-Leach-Bliley to acquire *any* commercial entity. This bill would preclude any commercial entity from establishing a bank to facilitate meeting the needs of its customers.

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 still 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 bank model represents only one of many options available for delivering financial services and products. Through that vehicle alone, billions of dollars of commercial and consumer credit have been made available to small businesses and individuals across the country. 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 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. It would be unwise to roll back the clock by taking steps to limit competition for the sake of upholding outdated principles, however noble they might sound, that are now simply irrelevant to the issue at hand.

Thank you.

Testimony
by
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Industrial Loan Companies

United States House of Representatives
Committee on Financial Services

April 25, 2007

Mr. Chairman, Ranking member Bachus and members of the committee, my name is James P. Ghiglieri, Jr., President of Alpha Community Bank, located in Toluca, Illinois. I am also Chairman of the Independent Community Bankers of America.[1] ICBA is pleased to have this opportunity to testify today on the need to close the industrial loan company loophole.

The ILC specter continues to loom over the nation's financial system. The ILC charter continues to threaten our nation's historic separation of banking and commerce and undermine our system of holding company supervision, harming consumers and threatening financial stability. The fact that Wal-Mart has withdrawn its application to establish a federally insured ILC does not diminish the need to close this loophole. Other applications are pending and more could be filed in the future. Only Congress can close the loophole once and for all by passing the Industrial Bank Holding Company Act of 2007 (H.R. 698). If Congress does not act, the FDIC's one-year moratorium will expire and the agency will begin processing commercial firms' ILC applications.

Federal Reserve Chairman Ben Bernanke recently cited previous Congressional action to maintain the separation of banking and commerce and highlighted the need for Congressional action in this case. He told the members of ICBA:

> "The Congress has been quite clear, most recently in the Gramm-Leach-Bliley Act, in support of the separation of banking and commerce. The financial holding company structure does not allow commercial firms to own banks or thrifts. In contrast, the ILC system allows for commercial firms to acquire ILCs without any restrictions. If Congress really wants to keep banking and commerce separate, it should take note of this problem."[2]

In one of his final letters as Federal Reserve Chairman, Alan 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

[1] 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.

[2] Remarks before ICBA's national convention March 6, 2007.

> 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.[3]

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.

As Chairman Bernanke noted, 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 still pending before the FDIC. Recent applicants have included nationwide retailers (Wal-Mart and Home Depot); auto companies (Ford[4] and Volvo); and investment giant Berkshire Hathaway. Several applications, including ones filed by the Blue Cross/Blue Shield Association (which obtained a thrift charter instead) and two credit union applicants (Wescom and a separate consortium) have been withdrawn due to regulatory uncertainty. And, as noted, Wal-Mart has withdrawn its application. However, the FDIC could face refilled applications or similar applications if Congress fails to act. And, even before these latest applications, the ILC industry had grown rapidly and come to dominate the banking industry in the State of Utah.

Congress never intended this result. In his testimony before the FDIC last year, 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 last 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."[5]

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[3] Letter to Rep. Jim Leach, January 20, 2006, (Greenspan letter to Leach)
[4] Ford recently withdrew its application for technical reasons, but has said it plans to refile.
[5] Greenspan letter to Leach.

Interestingly, on November 10, 1987, exactly three months after CEBA became public law, *American Banker* declared that "industrial banks, one of the curiosities of the financial services business, seem to be on a downward slide into oblivion." According to the story, Colorado's 152 industrial banks in 1983 had been reduced to only 89 by late October 1987.

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."[6] Greenspan added, "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 has increased by more than 500 percent just since 1999."[7]

This greatly increased activity threatens to propel a charter that exists in just a 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."[8] (emphasis in original)

Congress Should Enact the Industrial Bank Holding Company Act of 2007

Fortunately, Congress has before it an effective solution to this problem, the Industrial Bank Holding Company Act of 2007 (H.R. 698) introduced by Chairman Barney Frank and Representative Paul Gillmor. The bill is co-sponsored by a growing number of Members of the House from both sides of the aisle. The ICBA strongly endorses the new bill. We are joined by 88 state banking associations.

Chairman Frank and Representative Gillmor 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 the de novo interstate branching authority and the business checking powers. These provisions have repeatedly passed the House with restrictions on commercially owned ILCs.

Late last year, Chairman Frank and Representative Gillmor worked to obtain the signatures of over 100 Members of the House on a bi-partisan letter to the FDIC urging the agency to extend its moratorium on approving any applications for

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[6] Id.
[7] Id.
[8] Id.

deposit insurance for any new ILCs owned by commercial firms to give Congress an opportunity to consider the ILC issue.[9]

ICBA was pleased that the FDIC unanimously adopted this recommendation, providing for a one-year moratorium on ILC applications by commercial firms. This action by the FDIC demonstrated that the entire FDIC Board recognizes that these applications raise broad public policy issues that Congress must confront. We salute the FDIC and the many Members of Congress who have worked so hard to protect the integrity of the nation's financial system.

Now it is up to the entire Congress to address both elements of the ILC loophole – the separation of banking and commerce and the need for consolidated supervision of ILC holding companies – by enacting H.R. 698.

That bill 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 January 29, 2007 would be grandfathered, but could only engage in activities they were engaged in on January 28, 2007 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 as the consolidated regulator for all ILC holding companies.

Like much good legislation, H.R. 698 is a compromise. But, that is its strength. Institutions that are already in business could remain in place. Financial companies could continue to acquire, establish, and operate ILCs, just as they can with any type of bank. Thus, the legislation addresses the key concerns presented by the recent spate of ILC applications, without needlessly disrupting ongoing activity.

The bill provides the FDIC with most of the basic tools it will need to be an effective consolidated regulator. We recommend that this committee consult with the FDIC to ensure that the bill includes all the authority it needs.

Policy Reasons Why Congress Should Close the ILC Loophole

The rapid growth of the ILC industry 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

[9] Letter to The Honorable Sheila Bair, Chairman, FDIC, December 7, 2006.

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 Fund have a strong interest in maintaining its strength. Allowing commercial firms to own federally insured ILCs adds tremendous new risks to the DIF.

An example of these new risks was the application of Ford Motor Company for an ILC charter[10]. This was troubling. Last year, Ford posted a record $12.7 billion loss. It borrowed $23.4 billion late last year to cover an expected cash drain. They just sold their most profitable luxury brand, Aston Martin, for $632 million. Their S&P credit rating is B-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.

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.

The now-withdrawn Wal-Mart application illustrated this problem most starkly. 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 has 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 Home Depot has been profitable, the specialized nature of Home Depot and its ILC acquisition target EnerBank, make them susceptible to fluctuations in the economy, and especially real estate. According to Bloomberg News on February 21, "Home Depot reported its biggest drop in quarterly profit as a decline in U.S. home sales sapped demand for building supplies."

Because Home Depot is susceptible to such sudden changes, 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

[10] Ford withdrew its application for technical reasons, but could refile.

consumer installment loans for a broad range of home improvement projects"[11] (emphasis added)

Sudden changes in the home improvement market could send both Home Depot and EnerBank spiraling into a meltdown. The current difficulties in the home mortgage market are a troubling omen. 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. Before banking regulators could get a handle on the situation, their problems could have spilled over to their banks, draining the FDIC's resources and requiring all banks – including community banks – to cover the costs.

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, present conflicts of interest, and lead to customer confusion.

The mixing of banking and commerce presented 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 had gotten an ILC charter and expanded its business plan to take deposits from its customers, it is virtually impossible to believe that those deposits would have been lent to a competing business. In both cases, local businesses now served by local banks would lose a critical source of credit.

Home Depot will be tempted to direct its bank offer unsound loan terms to its customers – provided they agree to purchase products from Home Depot. Alternatively, Home Depot could offer discounts on its products if a customer takes out a loan from its bank. The first scenario would undermine the safety and soundness of a federally insured bank. The second scenario poses unfair competition to both banks without commercial affiliates and to local businesses that are not affiliated with a bank.

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[11] The Home Depot, Inc. Interagency Notice of Change in Control – Public, May 8, 2006, page 8.

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."[12]

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."[13]

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.

Proposed Home Depot/EnerBank Transactions Illegal

In fact, as structured the Home Depot/EnerBank arrangement appears to be predicated on illegal affiliate transactions under Section 23A of the Federal Reserve Act[14] 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

[12] Change in Control Notice, page 10.
[13] Change in Control Notice, page 10.
[14] 12 U.S.C. Section 371c.

Federal Deposit Insurance Corporation Act applies Section 23A to every nonmember insured bank in the same manner that it applies to a member bank.[15]

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."[16] 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.[17]

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 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 Expansion

In addition to its stated plan to stake out a major position in the nation's payments system, Wal-Mart could have easily changed its business plan and

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[15] See 12 U.S.C. Section 1828(j).

[16] See 12 U.S.C. 371c(a)(2) and 12 CFR 223.16.

[17] 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.[17] 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.

opened retail operations throughout its network of stores. Its establishment of a bank in Mexico and recently revealed changes in U.S. bank leases demonstrate that Wal-Mart continues to see retail financial services as a growth opportunity.

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 distant commercial owners of ILCs would not share in this commitment. For example, it has been demonstrated in community after community that 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.[18] 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 damage on community banks and thereby the communities they serve.

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

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[18] 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.

that it "already finance[s] home improvements with credit cards and home improvement loans marketed directly to consumers."[19] 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. Would the marginal benefit that would accrue to Home Depot outweigh the harm that would be inflicted on community banks in the way of diminished capacity? Given the importance of community banks to the communities they serve, the answer is clearly no.

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 that 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 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.

[19] Change in Control Notice, page 11.

Jeopardizes the Payments System

The Wal-Mart application highlighted another area of risk posed by the ILC loophole: risks to the objectivity and security of the payments system. Wal-Mart said that its business plan for the ILC was 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 had far-reaching and detrimental effects. A Wal-Mart bank could have provided 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 could have posed 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 proposed 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.

A Wal-Mart bank would have signaled a paradigm shift in the payments industry. To stay competitive, other retailers would have had 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.

Just because Wal-Mart has withdrawn its application doesn't mean that this threat to the payments system has gone away. Another company – or even Wal-Mart itself – could seek an ILC charter for these same purposes and pose the same dangers. Congress needs to act now.

Credit Union ILC Applications

Credit unions had also applied for ILC charters. In California, the giant Wescom Credit Union, with over $3 billion in assets, 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 were 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 was 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. Thankfully, the credit applications were withdrawn. But, like the Wal-Mart application, they could be revived or other credit union groups could make similar attempts.

Congress should step in as soon as humanly possible to clearly block credit union involvement in the ILC industry.

Enhanced ILC Supervision 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 Home Depot 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 financer, 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. That is why they provided Congress with an additional year to consider the issue. While ICBA believes that the FDIC has ample grounds under current law to deny several of the pending applications, especially Home Depot's, 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, ensure regulatory equity, 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 in 2005. It discussed the need for enhanced supervision of ILCs, 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.[20]

As I have indicated, in addition to preventing new commercial ownership of ILCs, H.R. 698 would address these supervisory issues. It merits rapid Congressional action.

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 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 still a number of applications for ILC charters or acquisitions pending today.

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[20] GAO report number GAO-05-621, 'Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority,' September 22, 2005.

More will almost certainly be filed unless Congress closes the loophole. 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 a strong legislative proposal that will effectively address these risks. But the clock is ticking down towards the end of the FDIC moratorium. ICBA urges Congress to take prompt and positive action.

March 21, 2007

The Honorable Nancy Pelosi
Speaker
U.S. House of Representatives
H-232 The Capitol
Washington, DC 20515

Dear Speaker Pelosi:

The undersigned state banking organizations support the Industrial Bank Holding Company Act of 2007 (H.R. 698). This legislation would maintain the separation of banking and commerce by preventing commercial firms from acquiring or establishing industrial loan companies (ILCs). It would also provide for regulation and supervision of ILC holding companies by the FDIC. This legislation is necessary to ensure equitable financial regulation, protect consumers and small businesses from conflicts of interest, and maintain the safety and soundness of the nation's financial system.

Sincerely,

Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
Arkansas Community Bankers Association
Bank Holding Company Association
Bluegrass Bankers Association
California Bankers Association
California Independent Bankers
Colorado Bankers Association
Community Bankers Association of Alabama
Community Bankers Association of Georgia
Community Bankers Association of Illinois
Community Bankers Association of Kansas
Community Bankers Association of New Hampshire
Community Bankers Association of Ohio
Community Bankers Association of Oklahoma
Community Bankers of Wisconsin
Connecticut Bankers Association
Connecticut Community Bankers Association
Delaware Bankers Association
Florida Bankers Association
Georgia Bankers Association
Heartland Community Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Independent Bankers Association of New York State
Independent Bankers Association of Texas
Independent Bankers of Colorado

Independent Banks of South Carolina
Independent Community Bankers Association of New Mexico
Independent Community Bankers of Maine
Independent Community Bankers of Minnesota
Independent Community Bankers of South Dakota
Independent Community Banks of North Dakota
Indiana Bankers Association
Iowa Bankers Association
Iowa Independent Bankers
Iowa's Community Bankers
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Association of Community Banks
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Massachusetts Independent Bankers Association
Michigan Association of Community Bankers
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Missouri Independent Bankers Association
Montana Bankers Association
Montana Independent Bankers
Nebraska Bankers Association
Nebraska Independent Community Bankers
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Jersey League of Community Bankers
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Association of Community Bankers
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Vermont Bankers Association
Virginia Association of Community Banks
Virginia Bankers Association

Washington Bankers Association
Washington Financial League
Washington Independent Community Bankers Association
West Virginia Association of Community Banks
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association

Testimony of

Amy Isaacs

on behalf of

Americans for Democratic Action

before the

House Committee on Financial Services

April 25, 2007

Washington, D.C.

My name is Amy Isaacs. I appreciate the opportunity to testify in my capacity as national director of Americans for Democratic Action representing our more than 65,000 members.

Unlike my colleagues on this panel, I am not an expert in banking. I am, however, a consumer as are the members of my organization and we have deep concerns about the impact granting an Industrial Loan Companies charter to any commercial enterprise will have on individual consumers and small business. It is, therefore, with great pleasure that we endorse HR 698, The Industrial Bank Holding Company Act of 2007.

Although the Industrial Bank Holding Company Act of 2007 is not specifically about Wal-Mart, I will focus the bulk of my remarks on Wal-Mart as perhaps the most pernicious example of the problems which can arise when banking and commerce are irrevocably intertwined. A bright line between the two must be firmly drawn.

We applaud Wal-Mart's decision not to pursue an ILC charter, if not its reasons. We opposed the granting of the charter for a number of reasons which could apply far beyond the Wal-Mart example.

Wal-Mart's application for a charter to enter the banking business was fraught with risk -- risk which, in the end, would have been guaranteed by the American taxpayer. A bank tied to one of the world's largest retailers would face unique commercial and reputational risks. We believe that the regulatory agencies charged with supervising these risks lack the experience or capacity to understand how to evaluate or minimize this risk.

One giant retailer after another has been forced into chapter 11 or has disappeared altogether because of sudden changes in the commercial environment. K-Mart, Woolworth, and Montgomery Ward are all examples of dominant retailers who lost their way, have been reorganized or have disappeared. Business models change as do consumer preferences. The changes are frequently rapid and unexpected. The federal government is not and should not be in the business of understanding the risks of large-scale retailing. It should not have to worry about the safety and soundness of a global retail business dependent on complex global supply systems.

For example, if a sudden shift in our trade relations with China should occur, Wal-Mart could face serious economic distress. Other business disasters are quite possible and each of them has little to do with the traditional process of bank examination. The reality is that if the retail operation faces disaster so will the bank. Depositors will flee and regulators will be in the business of a rescue.

Wal-Mart faces another kind of risk – the risk of social ostracism for its routine anti-social behavior. Wal-Mart, despite attempts to sugar coat its image, has an established pattern of irresponsible – some might say – unethical practices. It shorts employees on health care, it has flouted wage and hour laws, it has been involved in multiple cases of alleged discrimination. The company has been accused of using undocumented workers and has had a senior executive say he padded his expenses to conceal anti-union expenditures.

Anti-social behavior carries with it the risk of a damaged reputation and with it a run on the bank. The government cannot be in the position of insuring against that risk. There are many examples of anti-social behavior leading to the demise of financial institutions, the late Riggs Bank being just one example.

The record of Wal-Mart's anti-social behavior does not provide the picture of a company that is anxious to provide public service and meet community needs. It is the record of a company that could, as the result of some unforeseen incident, be the subject of public outrage when the outrage becomes public.

We are deeply concerned that Wal-Mart and other similar commercial enterprises will misuse their market power. As state chartered Industrial Loan Companies, the Wal-Mart Bank, or any other such entity, would not be subject to the stricter regulations of bank-holding companies. In this instance, we believe the world's largest retailer would quickly move to use its position in the market place and its control of prime real estate to become one of the largest banks in the United States.

We are also concerned about issues of privacy. Retailers already work hard to gather personal information about their customers. Examples of their efforts include

supermarket discount cards which allow the company to keep a record of everything you buy and credit card companies which sell information about customers purchasing patterns to direct mail marketers. The law allows individuals to opt out, but the law is weak indeed. It is bad enough that banks market other financial service products using customer information. What will Wal-Mart or others do with their customers' financial information? I submit that our imaginations are not adequate to the task of understanding the abuses that lie ahead.

Despite its claim that the Wal-Mart Bank would be used solely to process credit card, debit card and electronic check transactions from its retail outlets, it has made clear, in the past, its desire to become a full-service commercial bank. In fact, if Wal-Mart had been granted an Industrial Loan Company charter, it would have been able to offer everything an ordinary bank could: savings accounts, checking accounts, mortgages, and a variety of loans for everything from home improvement, to car purchases, to small business loans.

The potential for conflict of interest is obvious. Will Wal-Mart, for example, make loans to competitors? Should it have access to credit information about its competitors? Throughout its history, Wal-Mart has operated with the goal of dominating markets. It works to control competition in the areas where it operates. The result has been the extinction of many long-term community small businesses. There is no reason to believe that Wal-Mart's proposed foray into the banking industry would have been held to a different standard. In such instances, consumer protections would need to be stringent.

On March 15, 2006 Utah Governor John Huntsman, Jr. signed into law a bill that will allow lenders to protect themselves against class action suits in Utah and elsewhere. This bill appears to be an effort to make the Utah charter even more favorable for a bank that is likely to draw litigation and complaint from customers and employees. An institution proposing to meet community needs and provide important financial services should not need this kind of protection.

We reject the view that Wal-Mart is offering services to save customers money on transactions. The company, and other similar ones, is not a charity – it is in business to make money. Make no mistake; these companies want to use their retail power to muscle their way into the financial services industry in a big way. Such companies already offer paycheck cashing, money order purchases, money transfers, on-line credit reports and check printing. Wal-Mart has an entire subsidiary to promote and coordinate its financial services and leases space in many of its stores to other banks. Had it been granted a charter, it would have used its power to muscle past community banks and credit unions which really do care about their own communities.

Among the seven factors the law requires be considered in accepting an application for an ILC charter is "the convenience and needs of the community to be served." Mixing retail commerce and banking would make it impossible to meet that standard. The conflict of interest and the push for market dominance argue against a charter serving any need or convenience other than the retailers'. Existing institutions leasing space in a Wal-Mart or other similar store could just as easily serve the customers. Today, many banks have arrangements with supermarket chains. These bank branches meet the needs of customers and the needs of the community.

Another of those seven factors is "The general character and fitness of the management of the depository institution." By any objective review, Wal-Mart fails to meet that standard. There are many examples:

- Wal-Mart has proven its own inability to maintain accountability. They claim that their former Vice Chair Thomas Coughlin "misappropriated hundreds of thousands of dollars in corporate assets to pay for personal expenditures ranging from the petty to the extravagant." Coughlin subordinates have been implicated as well. Coughlin's defense is that he submitted false invoices to obtain reimbursement for secret anti-union activities which, if true, is in itself a serious violation of the federal labor law. Although Wal-Mart has submitted the case to a federal grand jury for investigation, it also fired the vice president who reported Coughlin's actions bringing into serious question its application of whistleblower protections.
- In addition, Wal-Mart repeatedly has been found systematically to hire undocumented workers. The federal government says they have wiretaps showing that Wal-Mart executive knew their company was using illegal workers and Wal-Mart was forced to pay an $11 million settlement to avoid prosecution. In an ironic twist, many of these workers were nightshift janitors who subsequently sued Wal-Mart alleging that the company knowingly coordinated their exploitation. Some of the plaintiffs earned a mere $325 for 60-hour weeks. Included in the lawsuit are

charges that Wal-Mart locked the janitors in stores overnight (a violation of safety laws) and sometimes refused to pay them at all.

- Over the years, Wal-Mart's record on discrimination has been appalling. The EEOC, in 1997 brought and won four cases involving race, gender and disability discrimination. Court records indicate Wal-Mart turns a blind eye to instances of sexual harassment. A suit was brought seeking class action status on behalf of more than 100 African American truck drivers denied employment by Wal-Mart. Yet, this is the same company applying for an ILC in a state which just enacted a law forbidding class action suits against lenders.
- Similarly, Wal-Mart is the nation's largest employer of women but it is falling far behind in promoting women. A committee to promote diversity was formed in 1998 but, subsequently, was disbanded with none of its recommendations implemented. In 2001, a class action suit was filed against Wal-Mart in California claiming gender discrimination in pay and promotion. The lawsuit, which began with six women, expanded to include as many as 1.6 million current and former female employees. Patterns of discrimination in promotion and pay were found in all regions where Wal-Mart operates.
- Further areas of concern, include repeated instances of violating child labor laws, wage and hour violations, and a combative approach to worker compensation claims that resulted in the state of Washington ordering the

company to relinquish control of its workers' compensation claims handling.

By any measurable standard, "The general character and fitness of the management of the depository institution" should have been found wanting and resulted in the rejection of Wal-Mart's application for an ILC charter bank. Wal-Mart clearly saw the handwriting on the wall when it withdrew its application. But, until and unless, the Industrial Bank Holding Company Act of 2007 is enacted and signed into law, we cannot be guaranteed that a Wal-Mart type problem or similar problem will not recur with a less auspicious outcome.

Americans for Democratic Action is an organization which stands for liberal values. We see bank regulation as an area where true conservative values should prevail. By granting a charter, and with it deposit insurance, the government should not be taking the risk of regulating a business it does not understand. It should not insure depositors against a corporation's anti-social behavior and the attendant reputational risk. It should leave banking to real bankers.

For these and other reasons, Americans for Democratic Action strongly urges you the passage of H.R. 698. Thank you for your consideration.

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Statement of

Donald L. Kohn

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

April 25, 2007

Chairman Frank, Ranking Member Bachus, and members of the Committee, I am pleased to appear today to provide the views of the Board of Governors of the Federal Reserve System on industrial loan companies (ILCs) and H.R. 698, the Industrial Bank Holding Company Act of 2007. The Board commends the Committee for holding this hearing and for considering ways of addressing the important public policy implications raised by the special exception for ILCs in federal law. ILCs are state-chartered banks that have virtually all of the powers and privileges of other insured commercial banks, including the protections of the federal safety net--deposit insurance and access to the Federal Reserve's discount window and payments system. Nonetheless, ILCs 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 without complying with the standards that Congress has established for bank holding companies to maintain the separation of banking and commerce and to protect insured banks, the federal safety net and, ultimately, the taxpayer.

We believe it is critical for Congress to consider and address the important public policy implications raised by the ILC exception, particularly in light of the dramatic recent growth and potential future expansion of banks operating under this special exception. If left unchecked, this recent and potential future growth of firms operating under the exception 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. The ILC exception also creates an unlevel competitive playing field by allowing both financial and commercial firms to own an insured bank but avoid the prudential limitations,

supervisory framework and restrictions on affiliations that apply to corporate owners of other insured banks.

The Board appreciates the steps that the Federal Deposit Insurance Corporation (FDIC) recently has taken regarding ILCs. These include extending the temporary moratorium on the acquisition of ILCs by commercial firms and seeking ways to help address the supervisory gaps caused by the ILC exception. However, only Congress can craft a solution that addresses the full range of issues created by the ILC exception in current law in a permanent, comprehensive and equitable manner. Your decisions on these matters, whether by action or inaction, also will influence the structure, soundness and resiliency of our financial system and economy. As I will discuss, the Board believes the best way to prevent this exception from further undermining the general policies that Congress has established and further promoting competitive and regulatory imbalances within the banking system is to *close* the loophole in current law going forward. This is precisely the approach that Congress has taken on previous occasions when earlier loopholes began to be used in unintended and potentially damaging ways. H.R. 698 would narrow, but not close, this loophole.

The ILC Exception and Its Origins

The BHC Act, originally enacted in 1956, provides a federal framework for the supervision and regulation of companies that own or control a bank and their affiliates. This comprehensive framework is intended to help protect the safety and soundness of corporately controlled banks that have access to the federal safety net and to maintain the general separation of banking and commerce in the United States. It does so principally in two ways. First, the act provides for all bank holding companies, including financial holding companies formed under the Gramm-Leach-Bliley Act (GLB Act), to be supervised on a consolidated or group-wide basis

by the Federal Reserve. And second, the act prevents bank holding companies from engaging in general commercial activities and allows bank holding companies that qualify as financial holding companies to engage only in those activities that Congress or the Board (in consultation with the Treasury Department, in certain cases) has determined to be financial in nature or incidental or complementary to a financial activity.[1]

The ILC exception allows a company to acquire an insured bank chartered in one of a handful of states--principally Utah and California--without becoming a bank holding company under the BHC Act and without abiding by the supervisory and regulatory framework established under that act. Ironically, the special exception for ILCs was enacted in 1987 as part of a broader legislative package designed to *close* an earlier loophole--the so-called nonbank bank loophole--that increasingly was being exploited by large commercial and financial firms to evade the nonbanking restrictions and consolidated supervisory requirements of the BHC Act. In 1987, Congress acted affirmatively to close this loophole by passing the Competitive Equality Banking Act (CEBA). That act 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). Importantly, the act also provided that, subject to certain limited exceptions, any company that acquired an institution meeting this expanded definition of "bank" would be subject to the same activity restrictions and supervisory and regulatory framework as other bank holding companies, including the prohibition on engaging in commercial activities.

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[1] Bank holding companies that do not qualify to be a financial holding company under the GLB Act are permitted to engage in a smaller range of activities that have been found to be "closely related to banking."

One of the exceptions adopted in CEBA was for ILCs chartered in those few states that, as of March 5, 1987, had in effect or under legislative consideration a law requiring ILCs to have FDIC insurance. At the time, the size, nature and powers of ILCs were quite restricted. 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. As of year-end 1987, the largest ILC had assets of approximately $410 million and the average asset size of all ILCs was less than $45 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 has now become the avenue through which large national and international financial and commercial firms have acquired a federally insured bank and gained access to the federal safety net. Indeed, dramatic changes have occurred with ILCs in recent years that 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. Since that time, Utah also has begun to charter new ILCs and to promote them as a method for companies to acquire a federally insured bank while avoiding the requirements of federal supervision and regulation under 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 just in the nine years between 1997 and 2006, with assets increasing by more than 750 percent (from $25.1 billion to $212.8 billion) and deposits increasing by more than 1000 percent (from $11.7 billion to $146.7 billion). In fact, in 2006 alone, the assets and deposits of ILCs increased by $62.7 billion and $38.8 billion, respectively. The number of Utah-chartered ILCs also has doubled since 1997, while declining in the few other states permitted to charter exempt ILCs.

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 approximately $410 million, the largest ILC today has more than $67 *billion* in assets and more than $54 *billion* in deposits, making it among the twenty largest insured banks in the United States in terms of deposits. An additional twelve ILCs each have more than $1 billion in deposits. And, far from being locally owned and focused on small-dollar consumer loans, many today are controlled by large, internationally active companies and are used to support various aspects of these organizations' complex business plans and operations.

While the growth of ILCs and diversity of ownership in recent years are impressive, it also is important to keep in mind that the exception currently is open-ended and subject to very few statutory restrictions. Although only a handful of states have the ability to charter exempt ILCs, there is *no* limit on the number of exempt ILCs that these states may charter, and the FDIC currently has several applications pending to establish new ILCs or to acquire existing ones.

Moreover, federal law places no limit on how large an ILC may become and only limited restrictions on the types of activities that an ILC 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. Nevertheless, some ILCs engage in retail banking activities by offering retail customers negotiable order of withdrawal (NOW) accounts--transaction accounts that are functionally indistinguishable from demand deposit accounts. In addition, federal law allows new or existing ILCs of any size to collect FDIC-insured savings or time deposits from institutional or retail customers and offer the full range of other banking services, including commercial, mortgage, credit card, and consumer loans; cash management services; trust services; and payment-related services, such as Fedwire, automated clearinghouse (ACH) and check-clearing services. Moreover, federal law permits ILCs to branch across state lines to the same extent as other types of insured banks. And, due to advances in telecommunications and information technology, some ILCs now conduct their activities throughout the United States--without physical branches--through the Internet or through arrangements with affiliated or unaffiliated entities.

Public Policy Implications of the Exception

Without action, further expansion of banks operating under this exception threatens to undermine several fundamental policies that Congress has established and reaffirmed governing the structure, supervision and regulation of the financial system. The ILC exception also fosters an unfair and unlevel competitive and regulatory playing field by allowing firms that acquire an insured ILC in a handful of states to operate outside the activity restrictions, consolidated supervision and regulatory framework that apply to other community-based, regional and diversified organizations that own a bank. Addressing these matters will only become more difficult if additional companies are permitted to acquire ILCs and operate under a different supervisory and regulatory regime than the owners of other insured banks. Let me discuss these

points in more detail and comment on how these matters would be addressed under H.R. 698, the Industrial Bank Holding Company Act of 2007, as introduced.

Bank Affiliations with Commercial Entities. For many years, Congress has sought to maintain the general separation of banking and commerce in the United States and has acted affirmatively to close loopholes that create significant 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.

In doing so, Congress was motivated by several concerns. One concern was that allowing the mixing of banking and commerce might, in effect, lead to an extension of the federal safety net to commercial affiliates and make insured banks susceptible to the reputational, operational and financial risks of their commercial affiliates. Congress also expressed concern that banks affiliated with commercial firms may be less willing to provide credit to the competitors of their commercial affiliates or may provide credit to their commercial affiliates at preferential rates or on favorable terms. Moreover, Congress expressed concern that allowing banks and commercial firms to affiliate with each other could lead to the concentration of economic power in a few very large conglomerates.[2]

Congress reaffirmed its desire to maintain the general separation of banking and commerce as recently as 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

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[2] *See* S. Rep. No. 100-19 (1987); S. Rep. No. 91-1084 (1970); H.R. Rep. No. 84-609 (1955).

association. At the same time and 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.

The ILC exception, however, has allowed several large commercial firms to acquire an insured ILC and additional commercial firms currently have ILC acquisition proposals pending before the FDIC. H.R. 698 would narrow, but not eliminate, the potential for further mixing of banking and commerce through the ILC exception. Importantly, the bill would allow any firm to acquire or establish an ILC in the future and derive up to 15 percent of its consolidated annual revenues from commercial activities. This 15 percent commercial "basket" is quite sizable and potentially would allow new firms that acquire an ILC to have significant commercial holdings. A large U.S. financial firm potentially could meet the 15 percent test in H.R. 698 even if it owned a commercial company the size of, for example, Kohl's, U.S. Steel, Waste Management, Office Depot or Nike.

No similar commercial "basket" exists for bank or financial holding companies, which generally are prohibited from engaging in commercial activities under the GLB Act. In fact, in passing the GLB Act, Congress rejected earlier 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.[3]

It also is unclear what activities would be considered "commercial" or "financial" for ILC owners under H.R. 698. The bill does not define "financial" activities by reference to the GLB Act and, thus, would allow the development of a different definition of "financial"

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[3] The GLB Act did provide certain nonbanking firms that became a financial holding company after November 1999, up to ten years to *divest* their impermissible commercial holdings if the firm was and remained "predominantly financial." *See* 12 U.S.C. § 1843(n). All commercial investments held under this authority must be divested no later than November 12, 2009.

activities than the definition established for financial holding companies in the GLB Act. This potentially would allow the owners of ILCs to engage in activities that would be "financial" under H.R. 698, but that would be considered commercial under the GLB Act.

The question of whether to allow firms engaged in commercial activities to own or acquire an insured ILC is one that has potentially far-reaching implications for the structure and soundness of the American economy and financial system. This is especially true because pressures likely will build to expand to banking organizations more generally any new policy applied to the owners of ILCs. Once permitted, any general mixing of banking and commerce also is likely to be difficult to disentangle. We believe it is important that Congress, as it has in the past, set the nation's policies with respect to the proper mixing of banking and commerce and consider carefully and deliberately whether any changes to the nation's policies on this important issue should be made. Once these decisions are made, we see no reason to generally exempt the owners of insured ILCs from the policies established by Congress: these policies should be applied to all owners of full-service insured banks.

Bank Affiliations with Financial Firms. Besides restricting the mixing of banking and commerce, Congress also has placed preconditions on the ability of banks to affiliate with firms that are purely financial. The GLB Act allows a bank holding company to engage in a broad range of financial activities, including securities underwriting, various insurance activities and merchant banking, only if the holding company keeps all of its subsidiary depository institutions well capitalized and well managed and achieves and maintains at least a satisfactory Community Reinvestment Act (CRA) record at all of the company's subsidiary insured depository institutions. These requirements help ensure that banks operating within a diversified financial

company remain financially and managerially strong and help meet the credit needs of their entire communities, including low- and moderate-income families and communities.

The ILC exception undermines these requirements by allowing financial firms to own and operate an FDIC-insured bank without abiding by the capital, managerial, and CRA standards established in the GLB Act. H.R. 698 does not address this significant regulatory disparity.

Consolidated Supervision. The ILC exception also undermines the supervisory framework that Congress has established for the corporate owners of insured banks. 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 and the Board has no concerns about the adequacy of this existing supervisory framework for ILCs themselves.

However, due to the special exception in current law, the parent company of an ILC is not considered a bank holding company. This creates special supervisory risks because the ILC's parent company and nonbank affiliates may not be subject to supervision on a *consolidated* basis by a federal agency. History demonstrates that financial trouble in one part of a business organization can spread, and spread rapidly, to other parts of the organization. Large organizations also 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.

It was precisely to deal with these risks to safety and soundness that Congress established a consolidated supervisory framework for bank holding companies that includes the

Federal Reserve as supervisor of the parent holding company and its nonbank subsidiaries in addition to having a federal supervisor for the insured depository institution itself. This framework allows the Federal Reserve to understand the financial and managerial strengths and risks within the consolidated organization as a whole and gives the supervisor the authority and ability to identify and resolve significant management, operational, capital or other deficiencies within the overall organization *before* they pose a danger to the organization's subsidiary insured banks. These benefits help explain why many developed countries, including those of the European Union, have adopted consolidated supervision frameworks and why it is becoming the preferred approach to supervision worldwide.

In the United States, the BHC Act has long provided the Federal Reserve broad authority to examine a bank holding company (including a financial 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.[4] 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 ongoing basis. These examinations, which are conducted using well-established procedures, manuals and systems, 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

[4] 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.

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.

Using its authority under federal law, the Federal Reserve also has established consolidated capital requirements for bank holding companies. These capital requirements help ensure that a bank holding company maintains adequate capital to support its group-wide activities, does not become excessively leveraged, and 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 and, as the FDIC has noted, may have no expectation that they should serve as a source of strength to their subsidiary ILC. 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.

Federal law also 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 failure to

monitor and address the risks in its nonbanking affiliates, 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, requiring mitigation of 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 a number of ILCs. For example, the FDIC noted in its recent rulemaking that some of the large corporate owners of ILCs tend to use these banks in ways that involve "unusual, affiliate-dependent" business plans and data show that seven of the ten largest ILCs each have more than $3 billion in assets but fewer than seventy-five full-time employees.

H.R. 698 takes an important step by recognizing that the potential lack of consolidated supervision of the parent and nonbank affiliates of an ILC creates special risks that should be addressed. The bill currently seeks to address these risks by granting the FDIC new supervisory authority for the existing and future corporate owners of ILCs (other than those that are already subject to consolidated supervision by a federal banking agency) that is similar to the authority that the Federal Reserve has with respect to bank holding companies. The Board strongly supports efforts to ensure that the existing corporate owners of ILCs are subject to consolidated supervision by a federal agency that has the same tools as the Federal Reserve to help protect the safety and soundness of insured banks and the federal safety net that supports those banks.

These tools include the ability to ensure that the holding company for an industrial bank acts as a source of strength for the bank. As I will discuss later, however, the Board also strongly believes that the ILC exception should be closed to new owners of ILCs.

Foreign Banks. In addition to constructing a consolidated supervisory framework for domestic banking organizations, Congress has made this type of supervisory framework a prerequisite for foreign banks seeking to acquire a bank in the United States. 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 U.S. bank or establishing a branch, agency or commercial lending company subsidiary in the United States.

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. This gap in current law needs to be addressed.

Fair Competition and Other Issues. The differences I have just discussed not only have safety and soundness consequences, they also have important competitive and structural consequences. The exception in current law creates an unlevel playing field among organizations that control a bank because it allows the corporate owners of ILCs to operate under a substantially different framework than the owners of other insured banks. H.R. 698 would perpetuate these competitive imbalances by continuing to grant firms that acquire an ILC significant advantages not available to the owners of other insured banks, such as the authority to engage in commercial activities and the ability to escape the CRA, capital and managerial requirements that apply to financial holding companies. These advantages will

provide incentives for firms to continue to exploit the exception. These differences also create the opportunity for firms to engage in "regulatory arbitrage" and, over time, may lead to shifts in the structure and supervision of the financial system and the Federal Reserve's ability to prevent or respond quickly to financial crisis.

Moving Forward

The Board believes the best way to address the important current and potential future public policy issues raised by the ILC exception is to close--and not just narrow--the loophole going forward. This approach recognizes the simple fact that ILCs *are* insured banks. Accordingly, it would require any company that acquires an ILC after a specified date to operate subject to the same activity restrictions, regulatory requirements and supervisory framework that apply to the corporate owners of other insured banks. This approach builds on and utilizes the existing regulatory and supervisory framework that Congress has established, and repeatedly reaffirmed, for the corporate owners of banks and creates a level playing field for all firms that acquire an insured bank in the future.

For reasons of fairness, the Board also supports "grandfathering" the limited number of firms that currently own an ILC and are not otherwise subject to the BHC Act. Such a grandfather provision would allow these firms to continue to engage in activities not permissible for bank holding companies. However, to protect the federal safety net and limit the potential for grandfathered ILCs to operate in ways clearly at odds with the original exception, the Board believes that any grandfathered firm should be subject to consolidated supervision by a federal agency and appropriate restrictions. We would be pleased to work with the Committee and its members in developing the appropriate restrictions that would apply to the limited set of grandfathered firms.

This type of coordinated solution--closing the loophole and "grandfathering" existing owners--is precisely the type of approach that Congress took in 1970, 1987 and 1999 in closing previous exceptions in the banking laws that were undermining the separation of banking and commerce and other important public policy objectives. It also is the right approach to fix the ILC loophole.

Conclusion

Thank you for the opportunity to discuss the Board's views on H.R. 698 and on the many important issues presented by ILCs. The Board and its staff would be pleased to continue to work with the Committee in developing and improving legislative language that appropriately addresses the core public policy issues raised by the ILC exception.

TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT AND CEO
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON H.R. 698
THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

April 25, 2007

Mr. Chairman and members of the Committee:

My name is Marc Lackritz and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] I appreciate the opportunity to testify today on H.R. 698, the Industrial Bank Holding Company Act of 2007.[2] SIFMA has a strong interest in issues relating to industrial banks because banks owned by SIFMA members hold the largest majority of all industrial bank assets in the United States.[3]

Congress passed the *Gramm-Leach-Bliley Act* ("GLBA") in 1999 to permit the widest variety of choices for affiliations between and among securities firms, banks and insurance companies. A central objective of GLBA was that each affiliated financial

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[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

[2] As a new organization, SIFMA's Board of Directors recently reviewed the industrial loan bank issue. The Board strongly supports the position outlined in the testimony, and noted the importance of dealing over the long-term with certain inconsistencies in the regulation of financial products and services (see page 7 for a fuller description).

[3] Insured industrial banks have about $130 billion in assets, which is less than 1.5 percent of total assets of all FDIC-insured institutions. Securities firms own the largest industrial banks and, collectively, control industrial loan banks that hold more than two thirds of total industry assets and deposits. 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 80 percent of the industry.

services entity would be functionally regulated – that is, regulated by the regulator with the regulatory expertise and statutory mandate to regulate the activities in which that entity engaged. The ability to structure their operations optimally within existing law has been critical to the success of industrial banks and their owners. Indeed, many of these companies are among the most advanced, sophisticated, and competent providers of financial services anywhere. For that reason, SIFMA supports the ability of regulated securities firms to own industrial banks the way they currently do under existing law.

H.R. 698 would create a new holding company regime for the owners of industrial banks by expanding the existing authority of the Federal Deposit Insurance Corporation ("FDIC") over the owners of these institutions. Bank and thrift holding companies that own industrial banks would be exempted from this regime, presumably because they are already subject to holding company oversight by the Federal Reserve Board ("FRB") or the Office of Thrift Supervision ("OTS"). However, the bill fails to provide an exemption for industrial bank owners who are regulated as "Consolidated Supervised Entities" ("CSEs") by the Securities and Exchange Commission ("SEC"). SIFMA believes it is critical that H.R. 698 be amended to recognize the SEC's CSE regime. Securities firms should be able to continue to charter and operate industrial banks without being forced to adjust certain business strategies in order to continue with the ILC charter. Congress can address its concerns about allowing industrial or other commercial companies to own industrial banks without diminishing securities firms' ability to own these banks.

Securities Firms' Ownership of Industrial Loan Banks

Members of the financial services community worked with Congress for decades to pass legislation to permit affiliations between and among securities firms, banks and insurance companies combined with functional regulation. After years of debate, discussion, and numerous failed attempts, Congressional leaders forged a political compromise between the relevant industries and Congress finally passed GLBA. GLBA gave financial services firms several structural options for affiliating with other firms. (1) They can choose to affiliate under a financial services holding company ("FSHC") structure regulated by the Federal Reserve Board, and each of the subsidiary financial services firms are regulated by their respective functional regulators. (2) Holding companies that own securities firms, and operate certain limited-purpose banks, can elect to be regulated as investment bank holding companies ("IBHCs"), which are subject to the jurisdiction of the SEC. (3) Securities firms and other companies can engage in banking activities through industrial loan banks and other special-purpose banks (including savings institutions, "non-bank banks," credit card banks) with supervision by the FDIC and state bank regulators. Securities firms that owned a thrift were permitted to retain their thrifts, subject to holding company supervision by the OTS.

Although at least one securities firm (Schwab) has elected to organize as a FSHC, most of the securities firms that wanted to provide banking services chose to do so through their affiliated industrial banks. This is because they cannot own full-service

commercial banks without exiting businesses that account for substantial segments of their revenues, such as commodities and merchant banking. Many SIFMA members consider these activities critical to their clients' needs and to well-functioning capital markets.

Industrial banks have a remarkably strong record of safety and financial strength. Most industrial banks, and all of the industrial banks owned by SIFMA members, are based in Utah. About 80 percent of Utah's bank assets are held in industrial banks and most of those are held in banks owned by SIFMA members. These Utah-based industrial banks serve a nationwide market, conducting more than 95 percent of their business out of state. Utah banks are far and away the strongest in the nation with the highest aggregate tier 1 capital and return on assets.[4]

Importantly, no industrial bank in Utah has failed in the last 20 years, even in one instance when an industrial bank's holding company went bankrupt.[5] In addition, industrial banks have an exemplary record of service to their customers and the community, with nearly 40 percent of the Utah industrial banks examined by the FDIC for compliance with the Community Reinvestment Act receiving "outstanding" ratings.

Regulation of Industrial Banks and their Owners

Securities firms with industrial bank subsidiaries are subject to multiple levels of supervision. Federally insured industrial banks are subject to state banking supervision, FDIC oversight, and all banking laws governing relevant banking activities. Most importantly, the FDIC has authority to examine the affairs of any affiliate of any depository institution, including its parent company.

Securities firms' broker-dealer affiliates are regulated by the SEC, and all of the SIFMA member securities firms with industrial bank subsidiaries have elected more comprehensive enterprise-wide regulation by the SEC acting as their consolidated supervisor. The SEC's jurisdiction does not limit the concurrent authority of the bank regulators. Most of the SIFMA member securities firms that own industrial banks also own savings institutions and are regulated at the holding company level as "savings and loan holding companies" by the OTS.

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[4] Federal Deposit Insurance Corporation *State Profile,* September 30, 2006. Utah banks' aggregate tier 1 capital was 13.27 percent; the national average is about 10 percent. Tier 1 capital is the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus ineligible intangible assets. The Core Capital (Leverage) ratio is Tier 1 Capital divided by adjusted average assets, as calculated in accordance with the FDIC's Statement of Policy on Risk-Based Capital. Utah banks' return on assets was 2.38 percent; the national average was about 1.3 percent.

[5] The collapse in 2002 of a prominent owner of an ILC, Conseco, for business reasons unrelated to the ILC, did not adversely affect its insured ILC. CRS Report RL32767, Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives, Jan. 3, 2007, p. CRS-8.

The FDIC's regulation of the bank and its affiliates, combined with measures to strengthen independent control of the bank, has worked well for securities firms, their customers and shareholders, and the financial services markets. Tested for 20 years on a broad scale and under the normal stresses and market cycles, the FDIC's regulation of industrial banks has proven safe and effective. Industrial banks pose no greater safety and soundness risks than other charter types. Very simply, no case has been made to require additional constraints on the industrial bank charter beyond those imposed on other FDIC-insured institutions.

SEC's Holding Company Supervision Program

The SEC established its CSE framework, in part, to allow major securities firms doing business in the European Union ("EU") to comply with the requirement of the EU's "Financial Conglomerates Directive." That Directive requires that non-EU firms doing business in Europe demonstrate that they are subject to a form of consolidated supervision by their home regulator that is "equivalent" to that required of their European counterparts. A firm failing to meet that test would lose its right to operate in the European marketplace – an unacceptable outcome for firms that derive significant revenues from Europe.

As a result, in 2004 the SEC introduced a voluntary consolidated supervision regime available to certain U.S. investment banks that were not regulated by the Federal Reserve as bank holding companies.[6] (Appendix A of this statement includes a detailed description of the SEC's Consolidated Supervised Entity oversight regime).[7] While the SEC traditionally focused on compliance with the securities laws by a firm's broker-dealer, the CSE framework extends supervision to the broker-dealer's holding company and affiliates, with particular attention to capital adequacy and risk-management practices. The option to be regulated as a CSE is available only to certain highly capitalized companies; essentially, the primary broker-dealer of each CSE must maintain tentative net capital of $5 billion and submit to a number of conditions with respect to the holding company and its affiliates.[8]

The SEC has examined the five CSEs (with a focus on the unregulated material affiliates) and concluded that the firms have generally well developed internal risk management controls and are compliant with the CSE rule. The SEC will continue

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[6] Rel. No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004).

[7] See also Hearings before the House Subcommittee on Financial Institutions and Consumer Credit, September 14, 2006.

[8] Including, but not limited to: computing capital consistent with the CSE Rule, a group-wide internal risk management control system, group-wide procedures to detect and prevent money laundering and terrorist financing, SEC examinations, providing financial and operational information, making examinations of other regulators available to the SEC, and acknowledging that the SEC can impose additional conditions under certain circumstances.

regular examinations, and expects "practices will continue to evolve, with CSEs remaining among the leaders in industry risk management standards."[9]

SEC Commissioner Annette Nazareth recently noted that the SEC's capacity to look globally at broker-dealer holding companies has been "dramatically expanded" as a result of the CSE program. The CSE approach is "similar to that applied by the banking regulators to their most complex holding companies. This convergence of approaches, spanning multiple regulatory jurisdictions and national boundaries, has been well received by the regulated entities and bodes well for greater convergence of approaches in the future."[10]

The Government Accountability Office ("GAO"), which last week released its report on CSEs, found that "the Federal Reserve, OTS, and SEC were generally meeting criteria for comprehensive, consolidated supervision."[11] Similarly, SEC Chairman Christopher Cox, responding to the GAO report, wrote that, "I am gratified that the GAO's report highlights many broad similarities between the Commission's CSE program and the Federal Reserve's oversight of bank holding companies, which is the obvious model for a program of this type. I am also pleased that the report recognizes certain differences between investment banks and commercial banks, and that these should be reflected in the holding company supervision provided to each type of institution."[12]

SIFMA agrees that the CSE regime is robust and comprehensive. Importantly, the SEC's CSE oversight, like the Federal Reserve's oversight of bank holding companies, meets the European Union's equivalency standard. Similarly, the standards used by the SEC for purposes of consolidated regulation closely parallel the standards used by the Federal Reserve to assess whether a foreign regulatory regime qualifies as consolidated regulation for a foreign bank operating in the United States.[13] As such, we strongly urge the Committee to recognize the SEC as a consolidated regulator along with the Federal Reserve and the OTS in H.R. 698. Specifically, the Committee should add industrial bank owners that are regulated as consolidated supervised entities to the

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[9] Speech by Mary Ann Gadziala, Associate Director, Office of Compliance and Examinations, SEC, before the Annual Regulatory Examination and Compliance Seminar, Institute of International Bankers, New York, NY, October 31, 2006. Available at: http://www.sec.gov/news/speech/2006/spch103106mag.htm.

[10] Speech by SEC Commissioner Annette L. Nazareth before the NABE 2006 Washington Economic Policy Conference, March 13, 2006, p. 2, Available at http://www.sec.gov/news/speech/spch031306aln_nabe.htm

[11] GAO Report 07-154, "Financial Market Regulation: Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration," U.S. Government Accountability Office, March 2007, p. 5.

[12] GAO Report 07-154, p. 77.

[13] 12 C.F.R. § 211.24(c)(ii).

bill's list of holding companies that are not subject to the new FDIC industrial bank holding company oversight.

This designation is critically important to the operations of many of the largest securities firms based in the United States. Failure to recognize the SEC as a consolidated regulator in this bill will diminish the agency's standing as a global regulator, particularly when it has already been recognized as such by other international regulators. In turn, the direct damage to the international operations of U.S.-based securities firms would be significant and long-lasting. As stated previously, firms would also be subject to duplicative and unnecessary holding company oversight by both the SEC and the FDIC.[14]

Additional Concerns with H.R. 698

SIFMA is also concerned with the grandfather provision in H.R. 698. All of the industrial banks controlled by SIFMA members would be "grandfathered" under the provision of the bill that prohibits commercial firms from owning or acquiring industrial loan banks. The bill provides that this grandfather is lost in the event of a "change of control" of the bank.

The change of control language was presumably intended to prevent an evasion of the new restriction on commercial ownership that might occur if a grandfathered industrial bank were acquired by a commercial firm that otherwise would be ineligible to own an industrial bank. However, the loss of control language as drafted is far broader. Under the bill, grandfather rights could be lost in the event of transactions (such as the acquisition of as little as 10 percent of the industrial bank owner's shares in the open market) that did not, in fact, bring about a transfer of ownership or operational control of the industrial bank to a commercial entity.

A loss of the grandfather rights could have serious consequences for a securities firm, subjecting it to a "commercial" entity test that might require the divestiture of the firm's industrial bank.[15] SIFMA believes that the change of control language must be

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[14] The SEC recognizes the importance of this designation as well. "The [CSE] rule amendments also respond to international developments. Affiliates of certain U.S. broker-dealers that conduct business in the European Union ("EU") have stated that they must demonstrate that they are subject to consolidated supervision at the ultimate holding company level that is "equivalent" to EU consolidated supervision. Commission supervision incorporated into these rule amendments is intended to meet this standard. As a result, we believe these amendments will minimize duplicative regulatory burdens on firms that are active in the EU as well as in other jurisdictions that may have similar laws." (Introduction to the SEC's consolidated supervision rules: *Federal Register, Vol 69, No. 118, Monday, June 21, 2004.)*

[15] H.R. 698 defines a "commercial firm" as an entity that derives more than 15 percent of its revenues from activities that are not "financial in nature" or "incidental to a financial activity." For many years, securities firms and investment banks have derived revenues from businesses that are not purely financial (*e.g.*, commodity trading, energy generation and transmission, real estate development, merchant banking), and it is possible that a firm's non-financial revenues could cross the 15 percent ceiling that would require a divestiture of its industrial bank. A company's gross revenues can fluctuate due to modifications in consumer/investor preferences, changes in the business cycle, fluctuations in

clarified to ensure that it does not cover transfers of control of an industrial bank to non-commercial entities like firms regulated as consolidated supervised entities by the SEC.

Comprehensive Review of the Financial Services Regulatory Structure Needed

Technological advances, shifting demographic trends, new forms of competition, and market innovations have transformed the financial services landscape to the benefit of investors, issuers, and the industry. Over the last two decades, capital markets and the financial services industry have become truly global, integrated and interconnected. In recognition of that trend, many other industrialized countries have consolidated their financial regulatory structures to better compete in today's global financial marketplace.[16] The United States, however, has not changed its regulatory structure substantially.

As capital markets and financial products continue to evolve, so too must our nation's regulatory structure. The United States needs a regulatory regime that is capable of keeping pace with rapid globalization, technological transformations, and dynamic market changes. That is why SIFMA's new Board of Directors unanimously agreed that SIFMA should develop a long-term strategy of seeking to harmonize financial services regulation and deal with the current asymmetry of regulation of banks and broker-dealers. We look forward to working with financial market participants, regulators and legislators to ensure a modern, innovative, globally responsive regulatory structure.

Conclusion

Industrial banks allow SIFMA member firms to provide much-needed banking services to their customers while posing no unusual safety and soundness risk. The industrial bank industry – comprised principally of deposits in banks operated by SIFMA member firms – has developed into one of the strongest and safest group of banks that ever existed. The current model for regulation of the holding companies and affiliates has been successful.

We feel strongly that SIFMA members that own industrial banks and are subject to consolidated regulation by the SEC should be exempt from the new FDIC holding company oversight regime created by H.R. 698. The SEC is recognized worldwide as a consolidated regulator, and its regulatory requirements and procedures were carefully

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interest rates, merger and acquisition activities, and other events not necessarily controllable by the bank owner.

[16] Regulatory consolidation has occurred, for example, in the United Kingdom, Germany, Japan, the Netherlands, and Australia. Germany, Japan, and the United Kingdom each have merged their regulatory structures into a single agency, while Australia and the Netherlands have consolidated their regulatory structures by assigning two of the major objectives of regulation – the safety and soundness of institutions and conduct-of-business, which includes market conduct, market integrity, and some aspects of corporate governance – to different regulatory agencies.

designed to comply with all standards for effective consolidated regulation in the United States and abroad. That stature should be reflected in this bill in order to ensure global securities firms are not damaged inadvertently.

We also urge the Committee to amend the bill's grandfather provisions to ensure that transactions that do not result in operational control of an industrial bank by a commercial firm are not covered.

Thank you for the opportunity to testify on this important legislation. We look forward to working with you, Mr. Chairman, the Committee, Congress and regulators to ensure our financial services industry retains its preeminent status in the world.

Appendix A
SEC Holding Company Supervision Program Overview
(Source: http://www.sec.gov/divisions/marketreg/hcsupervision.htm)

Consolidated Supervised Entities ("CSEs")

The Commission supervises certain broker-dealer holding companies on a consolidated basis. In this capacity, Commission supervision extends beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself. In supervising these Consolidated Supervised Entities ("CSEs"), the Commission focuses on the financial and operational condition of the group. The aim is to reduce the likelihood that weakness in the holding company or an unregulated affiliate endangers a regulated entity or the broader financial system. Like other consolidated supervisors overseeing internationally active institutions, the Commission requires CSEs to compute capital adequacy measures consistent with the Basel Standard.

A broker-dealer becomes a CSE by applying for an exemption from the standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision (if it does not already have a principal regulator).[1]

Under the alternative method for computing capital, contained in new Appendix E to Rule 15c3-1, firms with strong internal risk management practices may utilize the mathematical modeling methods they use to manage their own business risk, including value-at-risk ("VaR") models and scenario analysis to compute deductions from net capital for market risks and exposure modeling to compute deductions for credit risks related to over-the-counter derivatives. A broker-dealer calculating net capital adequacy using the alternative method must maintain tentative net capital[2] of at least $1 billion and net capital of at least $500 million. Moreover, if the tentative net capital of a broker-dealer using this alternative method falls below $5 billion, it must notify the Commission. The Commission then would consider whether to require the broker-dealer to take appropriate remedial action.

As noted above, the associated holding company must consent to a consolidated supervision regime if it does not already have a principal regulator. The ultimate holding company must execute a written undertaking in which it agrees, among other things, to do the following:

- Maintain and document an internal risk management control system for the affiliate group;
- Calculate a group-wide capital adequacy measure consistent with the international standards adopted by the Basel Committee on Banking Supervision ("Basel Standards");
- Consent to Commission examination of the books and records of the ultimate holding company and its affiliates, where those affiliates do not have principal regulators;
- Regularly report on the financial and operational condition of the holding company, and make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operations risks within the ultimate holding company and its material affiliates; and
- Make available examination reports of principal regulators for those affiliates that are not subject to Commission examination.

The ultimate holding company must provide the Commission with monthly, quarterly, and annual reports. The reports must include specified consolidated financial and credit risk information, including a consolidated balance sheet and income statement audited by a registered public accounting firm; the capital adequacy measurement (statements of allowable capital and allowances for market, credit, and operational risk); the results of a review by the internal auditor of the risk management and control system of the ultimate holding company; and certain reports that the ultimate holding company regularly provides

to its senior management to assist in monitoring and managing risk. The ultimate holding company must make and keep current records of funding and liquidity stress tests, the basis for the determination of credit risk weights for each counterparty, the basis for the determination of internal credit ratings for each counterparty, and a record of the calculations of allowable capital and allowances for market, credit, and operational risk.

These reports will assist the Commission in monitoring the financial condition, the risk management control system, and the activities of the affiliate group to detect any events or trends that may adversely affect regulated entities or the broader financial system.

Holding Companies With Principal Regulators

To avoid duplicative or inconsistent regulation, a reduced set of requirements applies to holding companies with principal regulators associated with broker-dealers that seek to apply the alternative method of computing net capital. These holding companies must execute a written undertaking in which they agree, among other things, to do the following:

- Make available to the Commission information on controls relevant to the broker-dealer but resident in the holding company;
- Make available to the Commission information about the ultimate holding company or any of its material affiliates that is necessary to evaluate financial and operational risks within the ultimate holding company and its material affiliates; and
- Make available to the Commission capital adequacy measurements computed in accordance with the standards published by the Basel Committee on Banking Supervision and provided to the principal regulator.

CSE Supervisory Program

The Commission's supervisory program with respect to CSEs has four components:

- First, the SEC staff reviews the application prior to action by the Commission. As part of the review, the staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application, and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.
- Second and following approval by the Commission, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with the Basel Standards.
- Third, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including statistical models; risk governance issues including modifications to and violations of risk limits; and the management of outsized risk exposures. In addition, there are quarterly meetings focused on financial results, the management of the firm's balance sheet, and, in particular, the liquidity of the balance sheet. Also on a quarterly basis, Commission staff meet with the internal auditor department to discuss implementation of the audit program as well as findings and reports that might bear on financial, operational, and risk controls. These regular discussions are augmented with focused work on risk management,

regulatory capital, and financial reporting issues of topical concern, which in some cases are pursued at several firms simultaneously.

- Fourth, the SEC staff conducts examinations of the books and records of the ultimate holding company, the registered broker-dealers (along with staff of the responsible self-regulatory organizations), and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

At present, five firms are subject to this regime: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

Holding Companies With Principal Regulators

The Commission's supervisory program with respect to a CSE with a principal regulator is distinct from that with respect to a CSE where the Commission has primary consolidated supervision responsibility for the holding company. The former relies significantly on the principal regulator to supervise the holding company, and thus focuses more narrowly on the broker-dealer. In general, the program in such cases consists of four parts.

- First, the SEC staff reviews the application prior to action by the Commission, as described above.
- Second and following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data. These reports include consolidating financials (which show intercompany transactions that are eliminated during the preparation of consolidated financial statements) as well as the consolidated capital calculations filed with the principal regulator.
- Third, the SEC staff meets at least semi-annually with senior risk managers to review the packages of risk analytics prepared for the firm's senior management. The focus is on the overall performance of the risk measurement infrastructure, and especially the mathematical models used to compute deductions from net capital in the broker-dealer.
- Fourth, SEC and self-regulatory organization staff conduct examinations of the books and records of the registered broker-dealer. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls, some of which may be resident in the holding company.

This overview of the Commission's consolidated supervision program for broker-dealers and affiliates was prepared by and represents the views of the staff of the Division of Market Regulation, and does not constitute rules, regulations or statements of the Securities and Exchange Commission. For further information, contact Michael A. Macchiaroli, Associate Director, Matthew J. Eichner, Assistant Director, or Thomas K. McGowan, Assistant Director at (202) 551-5530.

[1] The definition of principal regulator contained in the rules encompasses, inter alia, the Federal Reserve and foreign supervisory regimes recognized by the Board of Governors of the Federal Reserve System ("Federal Reserve").

[2] "Tentative net capital" is defined in the CSE rules as net capital before deductions for market and credit risk.

Testimony of

G. EDWARD LEARY

COMMISSIONER OF FINANCIAL INSTITUTIONS

STATE OF UTAH

Before the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

April 25, 2007

Good morning, Chairman Frank , Ranking Member Bachus and members of the committee, thank you for the opportunity to share Utah's view on H.R. 698, The Industrial Bank Holding Company Act of 2007 and its adverse effects on the industry.

I am Edward Leary, Commissioner of Financial Institutions for the State of Utah. I have been involved with banking for thirty-three years, first as a community banker, then fifteen years in bank examiner positions with the Utah Department and for the last fifteen years as its Commissioner. I am pleased to be here today to share my views on H. R. 698, The Industrial Bank Holding Company Act of 2007, and its adverse effects on the industry.

UTAH OPPOSES PASSAGE OF H.R. 698 FOR THE FOLLOWING REASONS

The Utah Department of Financial Institutions views H.R. 698 as unnecessary. Utah views passage of H.R. 698 as an effort to restrict and restrain state-chartered industrial banking without valid safety or soundness concerns or a crisis. In fact in Utah's view, there is no question of the competency of the regulators or of the regulatory regime. There has been no industrial bank failure warranting this change in public policy.

It is truly ironic that I am here today because of the success of the regulatory model not because of the failure of that model. Utah in partnership with the FDIC has built a regulatory model to which the financial services markets have reacted favorably. This regulatory model is not a system of lax supervision and inadequate enforcement. Utah industrial banks are safe, sound and appropriately regulated by both the state which charters them and the FDIC which is the relevant federal regulator and deposit insurance provider. I am told the articulated threat of the industry which warrants passage of this bill is a *"potential"* threat of misuse of the charter by holding companies which are *"non-financially"* oriented. This bill removes a *"potential"* threat even before the threat has materialized or has manifested itself. We should all be clear on the relative size of the industry. The industrial bank industry constitutes 1.8% of total banking assets. This is not a systemic crisis that threatens banking.

An analysis of the numbers as of December 31, 2006, developed by Utah indicates that Utah holds 88% of all industrial bank assets. Based upon our knowledge of the industrial bank holding companies, we estimate that 86% of Utah industrial bank assets would be considered held by *"financial"* entities and that 14% of Utah industrial bank assets would be considered held by *"non-financial"* entities.

Utah's analysis is that **seven** of Utah's industrial banks representing **80%** of Utah's assets are subject to consolidated federal agency supervision at the holding company level. The federal agencies we considered in the consolidated supervised entities are: (1) the Federal Reserve with jurisdiction over our 2nd largest bank, (2) the OTS with jurisdiction over our largest, 3rd and 4th banks among their five charters, and (3) the SEC with jurisdiction over our 6th largest bank.

The record of the last eighteen months is that no *de novo* industrial bank charter was approved by the FDIC from November 4, 2005 until March 20, 2007.

The primary punitive provisions of H. R. 698 target a large retailer that had applied for an industrial bank charter. As a result of that application, which was withdrawn, this bill will dismantle a Utah banking industry of thirty-one charters and a regulatory structure that has matured over twenty years with a record of safe, sound operations to forestall one entity from being granted an industrial bank charter. This bill with its provisions that are designed to block any and all conceivable ways in which a retailer may employ an industrial bank charter today or in the future are disappointingly, anti-competitive and anti-consumer.

The provisions contained within H.R. 698 are being justified under the pretext of preserving the prohibition against the merging of banking and commerce. The broad brush strokes of this bill include as collateral damage, large financial arms of entities which have been in the financial arena for decades such as DaimlerChrysler, Ford. The former submitted an application for an industrial bank charter in May of 2005 and receiving approval by my state a year ago. Now under the provisions of this bill will not be allowed to proceed. Another example is the GMAC Bank which under the bill's provisions will not be allowed to amend its business plan without risk of losing the charter. This is a tragic and inappropriate outcome when other auto lenders have the advantages of a bank charter.

The supporters of H.R. 698 present the bill as a compromise piece of legislation. I am challenged to determine how this bill is a compromise bill when industrial banks do not receive anything or have any of the current restrictions on its charter lifted, let alone given the right to issue commercial NOW accounts as has previously passed this Committee.

Again, the provisions of this bill further limit and restrict the ability of industrial banks to compete in the marketplace and reduce the charter's appeal.

For the record, the application for an industrial bank charter from the large retailer which caused all this damage was NOT accepted as complete by the Utah Department.

As a state regulator, what is most disappointing to observe is that while this Committee is aggressively moving H.R. 698, a bill which restricts and limits the one segment of state-chartered, federally insured banking that could be identified today as innovative and creative in the delivery of financial services to consumers and businesses, a historical tenet of state-chartered banking; Congress has not taken seriously the threat to state banking of the broad federal preemption of state laws by the Comptroller's Office. The states have been pleading for Congressional help in preserving dual banking. Many state commissioners believe that without Congressional intervention, the diminishing assets under state-charter will eventually render the state banking system irrelevant.

Utah notes that all should keep in perspective that industrial banking is approximately 1.8% of banking assets even with its growth during the last twenty years. This is not an industry which threatens the safety and soundness of banking. The regulatory model is not a "parallel" bank regulatory system in that 80% of Utah assets are subject to federal agency oversight at the holding company level.

UTAH INDUSTRIAL BANKS

As of December 31, 2006, all of the nation's 58 operating industrial banks represented a very small .7% component of the 8,681 total insured banks and savings banks. Nationally, industrial banks also represented a very small $213 billion of the $11.9 trillion of the insured bank and savings bank total assets or 1.8%.

Looking specifically at Utah industrial banks for the year ending December 31, 2006, Utah had 32 operating charters holding $186.2 billion in total assets. Thus, Utah holds 88% of all industrial bank assets. Utah industrial banks represent only 1.6 % of the insured bank and savings bank total assets and **1.7%** of total deposits with $132 billion of the $7.8 trillion in total insured bank and savings bank deposits. Currently there are 31 operating industrial bank charters as Volvo Commercial Credit was converted to a commercial bank charter and sold to NHB Holdings which commenced operations on January 16, 2007. (See Appendix -1) The foregoing percentages were determined by the Utah Department of Financial Institutions based upon numbers derived from the FDIC database as of December 31, 2006.

The statement has been made that there has been a *"stampede"* to the industrial bank charter. An analysis of the number of charters over the last twenty years will show that there has been on average an increase of one charter per year. (See Appendix - 2)

OWNERSHIP OF UTAH INDUSTRIAL BANKS

As of December 31, 2006, the Utah Department's, non-determinative and non-binding analysis using the provisions of H. R. 698 is listed in Appendix -3. The Utah Department's analysis based upon knowledge of the industrial bank holding companies is that 86% of Utah's industrial bank assets would be considered held by *"financial"* entities.

As of December 31, 2006, the Utah Department's, non-determinative and non-binding analysis using the provisions of H. R. 698 is listed in Appendix - 4. The Utah Department's analysis based upon knowledge of the industrial bank holding company is that 14% of Utah's industrial bank assets would be considered held by *"non-financial"* entities.

The increase in Utah industrial bank "*non-financial*" assets since the July 12, 2006 hearing before the Financial Institutions Subcommittee when Utah indicated that approximately 7% of industry assets were held in *"non-financially"*" owned industrial banks is largely attributable to Utah and FDIC's approval of the General Motors application to sell a 49% interest in GMAC. GMAC held a Utah industrial bank, the GMAC Automotive Bank. The FDIC granted an exception to its six-month moratorium on industrial bank applications and approved the sale and subsequent merger, which resulted in $16.3 billion in additional mortgage assets coming to the Utah industrial bank. The renamed GMAC Bank is considered a *"non-financial"* Utah industrial bank.

The Utah Department's analysis of those Utah industrial banks with a Consolidated Federal Agency supervising the holding company is listed in Appendix - 5. The Utah Department's analysis is that seven entities holding 80% of all Utah industrial bank assets are currently subject to a Consolidated Federal Agency Supervisor at the holding company level.

UTAH INDUSTRIAL BANK APPLICATIONS' STATUS

The Utah Department has received and/or approved the following industrial bank applications on the dates indicated.

Applications tentatively Considered *"Financial"*

Name of Institution	Date Received	Date Accepted	Date Utah Approved
Comdata Bank	8/18/2003	9/25/2003	12/19/2003
CapitalSource Bank	6/13/2005	8/16/2005	12/20/2005
Marlin Business Bank	10/6/2006	1/10/2006	Pending
ARCUS Financial Bank	2/2/2007	Pending	

Comdata Bank - plans to offer a *"Fleet Card"* and a *"Business Link Card."* The Utah Department has reviewed and extended its approval upon application to do so every six months after the lapse of the original one year conditional approval. The Utah Department has done this for the last three years awaiting FDIC's approval.

CapitalSource Bank - asset-based loans to commercial borrowers. The Utah Department has reviewed and extended its approval upon application to do so awaiting FDIC's approval.

Marlin Business Bank - small ticket commercial leases/loans. The Utah Department has not approved this application and will not continue the process until indication is received that the FDIC will approve.

ARCUS Financial Bank - an application filed after the FDIC announced it would consider applications from *"financial"* entities. The parent company is WellPoint, a health care provider.

Applications Considered *"Non-Financial"*

Name of Institution	Date Received	Date Accepted	Date Utah Approved
DaimlerChrysler	5/23/2005	7/6/2005	4/6/2006
Wal-Mart Bank	7/18/2005	(Withdrawn)	
American Pioneer	12/2/2005	2/13/2006	
Home Depot	5/8/2006	Pending	
Ford Motor Credit	9/22/2006	Pending	

DaimlerChrysler Bank - auto financing. The Utah Department has placed the application into an "*inactive status.*" The Utah Department will consider an extension request from the applicant. FDIC has announced it will not process the application due to a one year moratorium on applications from "*non-financial*" parent companies of industrial banks.

Wal-Mart Bank - card processing. The Utah Department did not accept the application as complete. The Utah Department placed the application into an *"inactive status."* The applicant announced on March 16, 2007 that the application would be withdrawn.

American Pioneer Bank - asset-based loans to commercial borrowers, which represent a joint venture between Cargill and Firstcity Financial. The Utah Department has accepted the application as complete but placed the application into an *"inactive status"* with the FDIC announcement that it will not process due to a one year moratorium on *"non-financial"* applications.

Home Depot - consumer loans. The Utah Department has not accepted the application for a change of control of EnerBank as complete. The Utah Department has placed the application into an "*inactive status.*"

Ford Motor Credit - auto financing. The Utah Department has not accepted the application as complete. The Utah Department has placed the application into an *"inactive status."*

Four points should be emphasized.

1. Until March 20, 2007, the last *de novo* Utah industrial bank application approved by the FDIC was LCA Bank on November 4, 2005, eighteen months ago.

2. While the Wal-Mart Bank application had been accepted as complete by the FDIC, it was never accepted as complete by the Utah Department. The applicant announced on March 16, 2007 that the application would be withdrawn.

3. A number of applications are received by the Utah Department which do not survive the approval process. Applications received by the Utah Department do not equate to applications approved. There is a robust application review and scrutiny of the character of the applicant, the expertise and experience of proposed management and directors, the assumptions and soundness of its proposed business plans, and the adequacy of its capital in relation to the business plans among many other items, which results in many applications being culled during the process.

4. Finally, the FDIC must independently approve deposit insurance for the applicants. A review of the foregoing will demonstrate that there is a robust review process where Utah has conditionally granted charter approvals on three applications but have not been approved by the FDIC.

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 federal preemption the states are losing assets and state-chartered depository institutions are becoming a less viable and appealing charter.

The following numbers illustrate the dramatic shift in percentage of assets by chartering agency.

Date	State	OCC	OTS
12/31/1995	41%	45%	14%
12/31/2000	42%	46%	12%
12/31/2001	41%	46%	12%
12/31/2002	42%	46%	12%
12/31/2003	41%	47%	12%
12/31/2004	31%	55%	13%
12/312005	31%	55%	14%
12/31/2006	30%	57%	12%

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.

In today's environment of decreasing assets in state-chartered institutions, industrial banks are experiencing asset growth. Why? Because of the innovations in customer service and delivery of financial products to targeted segments that consumers have responded to very well. Based upon 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 irony is that while many profess belief in the Dual Banking System and are staunch supporters of its merits in providing safe, sound banks with competitively priced financial services and products to consumers and businesses; we are here today to discuss H.R. 698, a bill that restricts and limits a state-chartered, federally insured banking industry that I believe embodies real innovation and creativity in the delivery of banking services. At a time when Congress has not taken seriously the threat of federal preemption of state laws by the Comptroller of the Currency to the state banking component of the dual banking system and states are clamoring for help in preserving dual banking. The action of this Committee is to further restrict a state-chartered entity, namely, the industrial banks.

A statement from the former Federal Reserve Chairman, Alan Greenspan, is an appropriate ending to this section.

> *"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

For the subcommittee hearing last July 12, 2006 on the industrial bank issue I entitled this section, "What The Public Policy Debate *Should* Be." It still seems like the appropriate title.

As previously stated, the fact that the committee 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.

The supporters of H.R. 698 present the bill as a compromise piece of legislation. I am challenged to determine how this bill is a compromise bill when industrial banks do not receive any powers

or have any of the current restrictions on their charter lifted, let alone given the right to issue commercial NOW accounts as has previously passed this Committee.

I want to be clear. This action is being taken today without a safety and soundness crisis in the industrial banks. There is no crisis of confidence in the industrial banks' regulators, both state and federal. Utah chartered industrial banks are as safe and as sound now as any institution existing today. There has not been an insurance loss in twenty plus years of FDIC insurance of Utah industrial banks. The only error of these institutions is that they: (1) are safe and sound, (2) have been largely successful business operations (3) and thereby may represent a competitive threat to some institutions and (4) an articulated potential future issue with the holding companies of some of the industrial banks, because they are "*non-financial*" in their businesses.

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 the Federal Reserve Act, 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 USA, American Express Centurion Bank and

Morgan Stanley Bank. The supervision of these large banks is coordinated by a full-time relationship manager from 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. This type of activity is no longer extraordinary.

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 plus years Utah has been involved in this program, a supervisory approach has been developed, tested, and refined expressly to address the special financial and compliance challenges posed by bigger, more complex and to some degree globally positioned banks.

The supervisory approach employed by Utah and the FDIC has been described as *"Bank-Centric."* Please review the John Douglas quote within the next section dealing with Banking & Commerce for a more detailed discussion of the *"Bank-Centric"* approach. 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

In reading the Committee's website and Dear Colleague letters, one sees repeated reference to statements such as, "H.R. 698, . . . ; a bill that will restore the traditional separation of banking and commerce." That H. R. 698 will resolve a, "*loophole*" in the Bank Holding Company Act.

The proponents of this argument state that this is a fundamental principle incorporated by the passage of the Glass-Steagall Act in 1933 while some observers believe this issue had been resolved with the passage of the Gramm-Leach-Bliley Act of 1999.

The proponents of the former argument subscribe to the conclusion that great *"evils"* result when banking and commerce are mixed. That somehow these great *"evils"* are compounded by the fact that Congress left this gaping hole through an oversight and this *"loophole"* may be exploited by commercial companies that will endanger the safety and soundness of our financial services sector and the deposit insurance funds.

Utah believes that the written testimony submitted by John L. Douglas, a former General Counsel of the FDIC, before the Subcommittee on Financial Institutions and Consumer Credit last July 12, 2006, states well our views on the primary issue of mixing banking and commerce and we incorporate a part of his testimony as ours.

"These first two assertions are simply historically inaccurate, and ignore the fact that throughout our history there have long been affiliations between banks and commercial firms. Indeed many of these 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, by the Bank Holding Company Act, the Competitive Equality Banking Act, the Federal Deposit Insurance Corporation Improvement Act and the Gramm-Leach-Bliley Act each address and bless, and regulate commercial affiliations with banks."

He states in his footnote number 1 on the Glass-Steagall Act that,

"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."

Mr. Douglas also stated in footnote number 3 that,

"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 place 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 "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."

He then goes on to address his key points which are germane for our discussion.

"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:"

"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; Regulation O, governing loans to officers, directors or their related interests; capital requirements; 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; 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, 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."

"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." 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, but also requiring that the condition be remedied and restitution made. Civil money penalties up to one million dollars per day can be imposed, 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. 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 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.

"Third, I can attest from experience that the FDIC regularly and vigorously exercises these powers. The FDIC routinely requires an independent, fully 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. 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" by 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 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 offered as cure for something that hasn't proven to be a problem."

"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.*

"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."

The industrial bank 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.

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

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 believes 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 federal financial regulators other than the Federal Reserve. The Office of Thrift Supervision (OTS) and Securities and Exchange Commission (SEC) have regulatory oversight over many holding companies with Utah industrial bank subsidiaries.

As previously stated, the OTS has supervisory responsibilities in five Utah industrial bank holding companies whose industrial banks collectively constitute 63% of all Utah industrial bank assets. The OTS has holding company jurisdiction because of affiliated federal savings banks to the Utah industrial banks.

The SEC has Consolidated Federal Supervisory responsibility over Goldman Sachs Bank's holding company whose industrial bank holds approximately 7% of total Utah industrial bank assets. The SEC has dual consolidated supervision authority with the OTS over three additional Utah industrial banks in total representing 56% of Utah assets.

The Federal Reserve has holding company supervision of UBS Bank's parent company which holds approximately 12% of total Utah industrial bank assets because UBS's parent filed as a Financial Holding Company with the Federal Reserve.

The federal agency oversight listed above constitutes approximately 80% of all Utah industrial bank assets as of December 31, 2006. This is not a parallel regulatory structure when federal agencies have holding company authority over 80% of all Utah industrial bank assets.

Not included in the federal agency oversight totals above but consideration should be given to three additional Utah industrial banks: Advanta Bank with $2.0 billion in total assets, Target Bank with $14 million, and World Financial Capital Bank with $193 million in total assets, all of which have sister national banks chartered by the Office of the Comptroller of the Currency (OCC).

Again, trying to keep this discussion in perspective, the entire industrial bank industry, even with its growth during the last twenty years, represents only approximately 1.8% of U. S. banking assets.

The parent companies of the vast majority of Utah 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 banking operations in Europe.

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 struggles 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. These entities control a third of industry assets and deposits, and a fourth of all bank branches.

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 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 partner, the FDIC.

H.R. 698 is unnecessary and restrictive of the industrial bank charter.

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 1.8% of banking assets.

UTAH INDUSTRIAL BANKS

31 IBs as of 12-31-06 (W/O Volvo)	12/31/2006 (000s omitted) Total Assets	Consolidated Bank Supervised Financial or SEC Regulated	Financial or Non-financial
ADVANTA BANK CORP	1,958,239		Financial
ALLEGIANCE DIRECT BANK	38,291		Financial
AMERICAN EXPRESS CENTURION B	21,096,810	OTS	Financial
BMW BANK OF NORTH AMERICA	2,219,777		Non-financial
CAPMARK BANK (GMACCM)	3,773,857		Financial
CELTIC BANK	95,490		Financial
CIT BANK	2,829,528		Financial
ENERBANK	147,265		Non-financial
ESCROW BANK USA	34,889		Financial
EXANTE BANK, INC.	391,308		Financial
FIRST ELECTRONIC BANK	14,179		Non-financial
GE CAPITAL FINANCIAL INC	1,991,805	OTS	Non-financial
GMAC BANK (auto)	19,937,022		Non-financial
GOLDMAN SACHS BANK – USA	12,648,880	SEC	Financial
LCA BANK CORPORATION (1-26-06)	18,483		Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,224,704	OTS	Financial
MAGNET BANK, INC.	458,699		Financial
MEDALLION BANK	309,489		Financial
MERRICK BANK	1,032,405		Financial
MERRILL LYNCH BANK USA	67,234,664	OTS	Financial
MORGAN STANLEY BANK	21,019,823	OTS	Financial
REPUBLIC BANK INC	437,486		Financial
SALLIE MAE BANK	438,860		Financial
TARGET BANK	14,213		Non-financial
THE PITNEY BOWES BANK INC	644,038		Non-financial
TRANSPORTATION ALLIANCE BANK	483,150		Non-financial
UBS BANK USA	22,009,139	Federal Reserve	Financial
VOLKSWAGEN BANK USA	665,342		Non-financial
WEBBANK	15,942		Financial
WORLD FINANCIAL CAPITAL BANK	193,427		Financial
WRIGHT EXPRESS FINANCIAL SERVICES	815,617		Financial
TOTAL UTAH INDUSTRIAL BANK ASSETS	**186,192,821**		
% of total ILC assets nationwide (58)	87.5%		
% of total insured banks/S&Ls (8,681)	1.6%		

Appendix - 1

UTAH INDUSTRIAL BANKS
NUMBER OF OPERATING CHARTERS BY YEAR

Year Ending	Number of Utah Industrial Banks Operating
1987	10
1988	13
1989	15
1990	15
1991	15
1992	15
1993	13
1994	12
1995	13
1996	13
1997	16
1998	18
1999	20
2000	23
2001	23
2002	24
2003	27
2004	29
2005	32
2006	32
3/22/2007	31

Appendix - 2

UTAH INDUSTRIAL BANKS
TENTATIVELY CONSIDERED *"FINANCIAL"*

22 "FINANCIAL" **31 IBs as of 12-31-06 (W/O Volvo)**	12/31/2006 (000s omitted) Total Assets	Consolidated Bank Supervised Financial or SEC Regulated	Financial or Non-financial
ADVANTA BANK CORP	1,958,239		Financial
ALLEGIANCE DIRECT BANK	38,300		Financial
AMERICAN EXPRESS CENTURION B	21,096,810	OTS	Financial
CAPMARK BANK (gmaccm)	3,773,857		Financial
CELTIC BANK	95,490		Financial
CIT BANK	2,829,528		Financial
ESCROW BANK USA	34,889		Financial
EXANTE BANK, INC.	391,308		Financial
GOLDMAN SACHS BANK – USA	12,648,880	SEC	Financial
LCA BANK CORPORATION(1-26-06)	18,483		Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,224,704	OTS	Financial
MAGNET BANK, INC.	458,699		Financial
MEDALLION BANK	309,489		Financial
MERRICK BANK	1,032,405		Financial
MERRILL LYNCH BANK USA	67,234,664	OTS	Financial
MORGAN STANLEY BANK	21,019,823	OTS	Financial
REPUBLIC BANK INC	437,486		Financial
SALLIE MAE BANK	438,860		Financial
UBS BANK USA	22,009,139	Federal Reserve	Financial
WEBBANK	15,942		Financial
WORLD FINANCIAL CAPITAL BANK	193,427		Financial
WRIGHT EXPRESS FINL SERVICES	815,617		Financial
TOTAL "FINANCIAL" INDUSTRIAL BANKS	**160,076,039**		
percentage of total Utah Industrial Banks (31)	86.0%		
percentage of total ILC assets nationwide (58)	75.2%		
percentage of total insured banks/S&Ls (8,681)	1.3%		

Appendix - 3

UTAH INDUSTRIAL BANKS
TENTATIVELY CONSIDERED *"NON-FINANCIAL"*

9 "NON-FINANCIAL" **31 IBs as of 12-31-06 (W/O Volvo)**	12/31/2006 (000s omitted) Total Assets	Consolidated Bank Supervised Financial or SEC Regulated	Financial or Non-financial
BMW BANK OF NORTH AMERICA	2,219,777		Non-financial
ENERBANK	147,265		Non-financial
FIRST ELECTRONIC BANK	14,179		Non-financial
GE CAPITAL FINANCIAL INC	1,991,805	OTS	Non-financial
GMAC BANK (auto)	19,937,022		Non-financial
TARGET BANK	14,213		Non-financial
THE PITNEY BOWES BANK INC	644,038		Non-financial
TRANSPORTATION ALLIANCE BANK	483,150		Non-financial
VOLKSWAGEN BANK USA	665,342		Non-financial
TOTAL *"NON-FINANCIAL"* INDUSTRIAL BANKS	**26,116,791**		
percentage of total Utah Industrial Banks (31)	14.0%		
percentage of total ILC assets nationwide (58)	12.3%		
percentage of total insured banks/S&Ls (8,681)	0.2%		

Appendix - 4

UTAH INDUSTRIAL BANKS
with
FRB, OTS, OR SEC HOLDING COMPANY SUPERVISION

SEVEN UTAH INDUSTRIAL BANKS WITH OTS, FRB OR SEC HOLDING CO. SUPERVISION 31 IBs as of 12-31-06 (W/O Volvo)	12/31/2006 (000s omitted) Total Assets	Consolidated Bank Supervised Financial or SEC Regulated	Financial Or Non-financial
UBS BANK USA	22,009,139	Federal Reserve	Financial
AMERICAN EXPRESS CENTURION B	21,096,810	OTS	Financial
GE CAPITAL FINANCIAL INC	1,991,805	OTS	Non-financial
GOLDMAN SACHS BANK – USA	12,648,880	SEC	Financial
LEHMAN BROTHERS COMMERCIAL BANK	3,224,704	OTS	Financial
MERRILL LYNCH BANK USA	67,234,664	OTS	Financial
MORGAN STANLEY BANK	21,019,823	OTS	Financial
TOTAL "FRB, OTS, SEC" INDUSTRIAL BANKS	**149,225,825**		
percentage of total Utah Industrial Banks (31)	80.1%		
percentage of total ILC assets nationwide (58)	70.1%		
percentage of total insured banks/S&Ls (8,681)	1.3%		

Appendix - 5

April 25, 2007

Testimony of

Earl D. McVicker

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Financial Services

Of the

United States House of Representatives

Testimony of Earl D. McVicker
Chairman and Chief Executive Officer, Central Bank and Trust of Hutchinson, Kansas
on Behalf of the
American Bankers Association
before the
Committee on Financial Services
of the
United States House of Representatives

April 25, 2007

Mr. Chairman and members of the Subcommittee, my name is Earl D. McVicker. I am Chairman and Chief Executive Officer of Central Financial Corporation and Central Bank and Trust Co., headquartered in Hutchinson, Kansas. I also serve as Chairman of the American Bankers Association ("ABA"), and 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 in the last several years. Since Congress last enacted legislation concerning the ownership of ILCs, the industry has experienced extraordinary growth. This growth threatens to undermine prior decisions by Congress to maintain separation between banking and commerce.

Legislation that was recently introduced by Chairman Frank and Congressman Gillmor offers an appropriate means for addressing the current situation. H.R. 698 would create a general rule that commercial firms may not own an ILC. The bill preserves the

historical separation of banking and commerce and avoids problems, such as conflicts of interest and misallocation of credit, that arise when the two are mixed. The ABA strongly supports the Frank-Gillmor bill.

In my statement today I would like to make three points:

- The current policy toward ILCs is inconsistent with the long-standing tradition of separation between banking and non-financial commerce.

- The ILC exemption created by Congress in 1987 is no longer appropriate for the ILC industry of today.

- Congress should once again prevent the mixing of banking and non-financial commerce and should enact the Frank-Gillmor bill.

These points are addressed in further detail below.

I. The Current Policy Toward ILCs is Inconsistent With the Longstanding Tradition of Separating Banking and Non-Financial Commerce.

The separation of banking and commerce has long been a feature of U.S. law. Exploitation of the ILC exemption threatens to undermine this consistent policy.

Over the past fifty years, Congress has repeatedly curtailed the ability of non-financial commercial entities to engage in banking activities. The Bank Holding Company Act, passed in 1956, was designed in part to restrain the ability of commercial firms and

financial institutions to organize under a single holding company. It prohibited commercial firms from owning banks and also prohibited holding companies that owned two or more banks from engaging in non-financial commercial activities.

However, the law did not prevent holding companies that owned only a single bank from also owning non-financial commercial entities. Some non-financial entities stepped into this void and organized under so-called "one-bank" holding companies. By 1970 there were more than 700 such companies, and Congress determined to curtail this activity. Amendments to the Bank Holding Company Act prohibited non-financial commercial entities from owning a single bank through "one-bank" holding companies.

Despite the change, some commercial entities still sought ways to engage in banking activities. At the time of the 1970 amendments, the definition of "bank" in the Bank Holding Company Act included only entities that offered commercial loans *and* accepted demand deposits. A number of large retail commercial entities exploited this provision by acquiring financial institutions that made loans but did not offer demand deposits. These so-called non-bank banks allowed commercial entities to avoid supervision as bank holding companies while offering banking services on an interstate basis.

Once again, Congress intervened to address the situation and enacted the Competitive Equality Banking Act ("CEBA") in 1987. One of the primary purposes of this legislation was to subject non-bank banks to interstate banking restrictions. CEBA prohibited the creation of any new non-bank banks and amended the definition of "bank" in the Bank Holding Company Act to mean any institution that was insured by the Federal Deposit Insurance Corporation ("FDIC"). Thus, CEBA blocked the ability of prospective

owners of non-bank banks from creating more institutions that combined banking and commerce.

Most recently, Congress enacted the Gramm-Leach-Bliley Act, which allows financial holding companies ("FHCs") to own commercial banks, securities houses, insurance companies, and other financial entities. Commercial firms may not be, or own, FHCs. Moreover, the Gramm-Leach-Bliley Act put an end to the ability of non-financial commercial firms to become unitary thrift holding companies. The report of the Senate Banking Committee states that "[a]llowing these thrifts to be acquired by commercial firms would move far down the road toward mixing banking and commerce, with all its attendant dangers."[1]

Thus, the legislative history is clear. Time and again Congress has enacted or amended legislation with the specific goal of maintaining separation between banking and non-financial commerce.

II. The ILC Exemption Created By Congress in 1987 is no Longer Appropriate for the ILC Industry of Today.

At the time Congress enacted CEBA and amended the definition of "bank" to include any financial institution that is FDIC insured, most ILCs were FDIC insured, and some states even *required* them to be. This meant that ILCs fell squarely within the new definition of "bank" and could not be owned by non-financial commercial entities. However, Congress also included an exemption in CEBA specifically stating that the term

[1] Senate Report 106-44 of the Committee on Banking, Housing, and Urban Affairs, April 28, 1999.

"bank" does not generally include ILCs if they meet one of a handful of conditions.[2] Interestingly, the legislative history of CEBA does not offer much insight as to why the ILC exemption was included. In recent testimony given before this Committee, the Federal Reserve Board makes note of this fact and suggests that the exemption may be due to the fact that the size, nature and powers of ILCs were rather limited in 1987.[3]

Indeed, ILCs were originally created in the early 1900s to provide uncollateralized consumer loans to low- and moderate-income workers unable to obtain such loans from existing commercial banks.[4] At the time CEBA was enacted, most ILCs had less than $50 millon in assets and the exemption applied to only a few, small institutions. Furthermore, the few states that were able to charter ILCs – principally California, Nevada, and Utah – were not promoting the charter. In fact, Utah had a moratorium at the time on the creation of new ILCs.

Simply put, 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.

This is not the case today. Between 1987 and 2006, aggregate ILC assets grew more than 5,500 percent, from $3.8 billion to almost $213 billion, with the average ILC holding close to $3.7 billion in assets.

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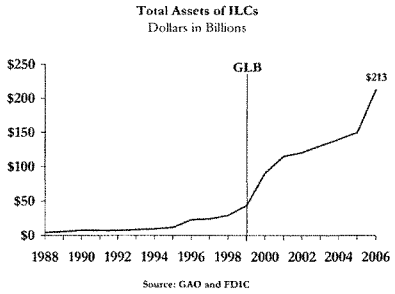
[2] The conditions include: (1) the ILC does not accept demand deposits that can be withdrawn by check or similar means; (2) the ILC maintains total assets of less than $100 million; or (3) the ILC has not undergone a change in control after 1987. Only ILCs chartered in states that, as of March 5, 1987, had in effect or under consideration a law requiring ILCs to be FDIC insured were eligible for the exemption.
[3] Testimony of Scott G. Alvarez, General Counsel of the 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.
[4] GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

This growth is not by accident. Enactment of the Gramm-Leach-Bliley Act in 1999 cut off the ability of non-financial commercial entities to engage in bank-like activities through unitary thrift holding companies. Commercial firms that still wanted to engage in banking activities were forced to look for other means of doing so. It is no coincidence that a monumental increase in total aggregate assets held by ILCs occurred shortly after Gramm-Leach-Bliley was enacted. According to a recent report by the Government Accountability Office, total ILC assets amounted to over $43.6 billion in 1999. In 2000, total ILC assets more than doubled to over $90 billion.[5] As noted, total aggregate assets reached almost $213 billion in 2006 (see chart at right).



Even during the debate leading up to enactment of Gramm-Leach-Bliley there was significant activity with respect to ILC asset growth. The major tenets of that landmark legislation had been under discussion for years in Congress. In 1995, the first bill addressing ownership of unitary thrift holding companies was introduced. Though not enacted at the time, the Financial Services Competitive Act of 1995 sent a clear signal that curtailing the ability of non-financial commercial firms to own a unitary thrift holding company would be a part of the debate going forward. It also provided impetus for commercial firms to shift their assets from thrifts to ILCs. Indeed, between 1995 and

[5] GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

1999, the year Gramm-Leach-Bliley was enacted, total aggregate ILC assets almost quadrupled from $11.5 billion to $43.6 billion.

Thus, when Congress finally closed the unitary thrift avenue in 1999, non-financial commercial entities that still wanted to engage in financial activities rushed to exploit another. This time they turned to the ILC exemption that Congress had created more than a decade earlier. Though the policy reasons behind the ILC exemption are unclear, it is fair to assume that Congress did not anticipate that the ILC exemption would become a vehicle by which non-financial commercial firms would journey deep into the realm of banking.

Because federal law places only limited restrictions on the types of activities that an ILC operating under the exemption may conduct, commercial firms look to them as viable options. A recent report by the FDIC states that "the ILC charter has been an attractive choice for companies that are not permitted to, or choose not to, become subject to the restrictions of the [Bank Holding Company Act]. As a result, it is not surprising that the parent companies of ILCs include a diverse group of financial, and where permitted, commercial firms."[6]

Furthermore, while the ILCs may only be chartered in a handful of states, there is no limit to the number of ILCs these states may charter. To date, there are a total of 58 FDIC insured ILCs nationwide, with another eight applications pending.

Federal law allows ILCs to effectively compete with full-service insured depository institutions. ILCs may branch across state lines to the same extent as other types of insured banks, and modern technology ensures that ILCs have the ability to conduct their activities nationwide, even without physical branches. As observed by former Federal Reserve Chairman Alan Greenspan, ILCs may engage in the "full range of commercial,

[6] FDIC Banking Review, 2004. Volume 16, No. 4 at 113.

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."[7]

Hence, the industrial banks of today do not resemble the small ILCs of yesteryear that were created to make uncollateralized loans to industrial workers. Instead, they are increasingly large, sophisticated commercial firms that are using provisions of law in a manner that contravenes the consistent desire of Congress to maintain separation between banking and non-financial commerce.

III. Congress Should Once Again Prevent the Mixing Of Banking and Commerce and Should Enact the Frank-Gillmor Bill

The current ILC exemption threatens to erode the separation of banking from non-financial commerce. Congress should act, as it has many times before, to ensure that the potential dangers associated with this erosion do not become a reality. The rationale for maintaining separation between banking and non-financial commerce is clear. Banking is a critical component of our economy and is carefully regulated for safety, soundness, and systemic risk.

Allowing banks to mix with commercial firms 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

[7] Letter from Federal Reserve Board Chairman Alan Greenspan to Congressman James Leach dated January 20, 2006.

subsidiary to grant credit to customers of the firm 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 customary banking considerations have the potential to threaten the safety and soundness of the bank. Moreover, they pose a related risk to the federal deposit insurance system and encourage abusive financial practices. This 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. Non-financial firms may also be tempted to use a subsidiary bank to serve the firm's commercial purposes instead of serving as a source of strength for the bank.

Simply put, any general mixing of banking and commerce is likely to be difficult to disentangle down the road. Congress has recognized the dangers inherent in mixing the two activities many times before and has consistently acted to prevent these dangers from becoming reality.

By offering a means for non-financial commercial entities to obtain ownership or control of a bank through an ILC charter, the current ILC exemption increases the likelihood that the risks associated with mixing banking and commerce will become problems. 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 supports the Frank-Gillmor bill, H.R. 698.

This legislation would create a general rule that commercial firms – defined as those deriving at least 15 percent of their consolidated revenues from non-financial activities – may not own an ILC. In order to strike a balance going forward, the bill contains provisions that would, in varying degrees, grandfather commercial firms that currently own an ILC. We support bringing any grandfathered institution within the jurisdiction of a federal bank regulator and vesting that regulator with the full range of supervisory and enforcement tools necessary to protect the insured depository institution or its holding company.

CONCLUSION

Congress has repeatedly and consistently taken steps to maintain separation between banking and non-financial commerce. When it created the ILC exemption in 1987, Congress could not have anticipated that it would be exploited by commercial firms seeking a back-door entry into the realm of banking. The Frank-Gillmor bill offers a means to address this situation before the various problems associated with mixing banking and commerce arise.

Embargoed until
April 25, 2007, at 10:00 am

Statement of

John M. Reich, Director,
Office of Thrift Supervision

concerning

Industrial Loan Companies

before the

Committee on Financial Services
United States House of Representatives

April 25, 2007

Office of Thrift Supervision
Department of the Treasury

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Statement on Industrial Loan Companies
before the
Committee on Financial Services
United States House of Representatives

April 25, 2007

John M. Reich, Director
Office of Thrift Supervision

I. Introduction

Good morning, Mr. Chairman, Ranking Member Bachus, and Members of the Committee. Thank you for the opportunity to address issues related to the activities, ownership and control of industrial loan companies (ILCs). In particular, I understand that you seek the Office of Thrift Supervision's (OTS) views on the supervision and oversight of savings and loan holding companies (SLHCs) that own and/or control ILCs. Finally, you seek comment on H.R. 698, the Industrial Bank Holding Company Act of 2007, which was introduced by you, Mr. Chairman, and Congressman Gillmor, on January 29, 2007.

Mr. Chairman, I wish to commend you, Mr. Gillmor and other Members of this Committee on the introduction of H.R. 698. It addresses several pending policy issues with respect to the key areas of the permissible activities and oversight of companies that own or control, or seek to acquire or control, an ILC. I applaud your leadership in addressing these important policy matters. For my part, I appreciate the recognition in H.R. 698 of the important role that the OTS has in overseeing and supervising several of the largest companies that currently own and control ILCs. As you know, functional

regulation and consolidated regulatory oversight have been important considerations in recent legislation supported by this Committee. H.R. 698 maintains this forward-looking focus on maintaining the enterprise-wide safety and soundness of holding companies that own or control institutions with access to the federal safety net.

If the concern is the potential exposure of the federal safety net to a company that owns or controls an ILC, then the issue is not one of who regulates the entity, but rather how best to understand and supervise the interrelationships within the structure and how the ILC is integrated. An effective holding company regulator oversees the parent holding company of an ILC or other insured depository institution without imposing draconian operating restrictions or other requirements. The OTS expects entities that it regulates to manage the risks within their operations. We use a risk-focused, top-down examination methodology that weighs a company's ability to manage these risks.

Effective oversight of holding companies requires having adequate government controls to monitor and intervene when necessary without unduly interfering with the ongoing business operations and activities of the enterprise. It is a delicate balance that requires judgment based on expertise in a wide range of areas. The OTS focuses and tailors its supervision of SLHCs based on the complexity of the structure and the level of risk inherent in the holding company enterprise. Comprehensive supervision of SLHCs is a combination of ongoing off-site monitoring, targeted reviews, and on-site examinations. This combined approach permits the OTS to gain an understanding of the business and its inherent risks, as well as the affiliations and the transactions of the enterprise. It also

enables us to assess the potential impact on the broader economy, the insured depository institution and the potential exposure to the federal safety net.

In order to understand the OTS's perspective on holding company oversight and its role in supervising companies that own or control ILCs, it is necessary to understand the development of the ILC structure, as well as how the OTS evolved as the supervisor of numerous ILC holding company structures.

II. Overview on the Development of ILCs and Current Demographics

ILCs have existed since the early 1900s, when a number of small, state-chartered institutions formed to provide a source of unsecured loans to industrial workers who did not have access to financial services at traditional depository institutions. For many years, these small entities remained focused almost entirely, if not exclusively, on serving their existing customer base of industrial workers.

During the last 25 years, however, ILCs have grown considerably in size and number. This growth in assets and aggregate numbers was driven substantially by the eligibility of ILCs for federal deposit insurance in 1982. Also increasing the attractiveness of the ILC charter was legislation in 1987 that exempted companies that own ILCs from the ownership restrictions of the Bank Holding Company Act (BHCA). Pursuant to these statutory provisions, ILCs are state-licensed, insured depository institutions regulated by their respective state bank supervisor as well as the FDIC under

the Federal Deposit Insurance Act (FDIA). They are not considered "banks" under the BHCA.[1] As a result, ILCs are currently not subject to holding company oversight unless the parent company also owns or controls a bank or thrift. Similarly, ILCs are not currently prohibited from commercial affiliations, including being owned or controlled by a commercial company.

Today, although only a handful of states continue to charter ILCs, the charter is thriving. As of December 2006, there were 60 institutions holding more than $213 billion in aggregate assets. While the five largest institutions dominate the industry, holding $151 billion or roughly 71 percent of aggregate industry assets, 17 of the 60 institutions have assets in excess of $1 billion. And as you are aware, interest in the ILC charter has never been higher. For various reasons, including interest by commercial

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1. Section 2(c)(2)(H) of the Bank Holding Company Act (12 U.S.C.A. § 1841(c)(2)(H)) provides that the term "bank" does not include "An industrial loan company, industrial bank, or other similar institution which is –

> (i) an institution organized under the laws of the 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; or
>
> (ii) an institution which does not, directly, indirectly, or through an affiliate, engage in any activity in which it was not lawfully engaged as of March 5, 1987,

except that this subparagraph shall cease to apply to any institution which permits any overdraft (including any intraday overdraft), or which incurs any such overdraft in such institution's account at a Federal Reserve bank, on behalf of an affiliate if such overdraft is not the result of an inadvertent computer or accounting error that is beyond the control of both the institution and

companies in chartering ILCs to perform various finance-related activities, applications continue to be filed with the FDIC by ILCs seeking federal deposit insurance.

H.R. 698 addresses the lack of clear statutory authority for a federal regulator of an ILC holding company that does not otherwise own a bank or thrift. From a policy standpoint, it is our view that the Frank-Gillmor bill, as introduced, achieves all of its intended objectives.

As the discussion of this legislation unfolds, the OTS is particularly interested in maintaining the status quo for SLHCs that own ILCs. A number of prominent companies fall into this category. I appreciate the recognition in H.R. 698 of OTS's continued role as the prudential holding company regulator of these entities. In my experience, understanding the organizational structure and culture of each regulated institution is crucial to effective oversight of the enterprise and protection of the federal safety net. It is also essential to supervise all aspects of the affiliations with the insured depository institution, including inter-company transactions. We have significant experience performing strong consolidated supervision over some of the most complex firms in the world. The OTS appreciates the deference shown in the bill to our holding company supervision program.

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the affiliate, or that is otherwise permissible for a bank controlled by a company described in section 1843(f)(1) of this title."

III. OTS Oversight of ILCs in SLHC Structures

As of December 31, 2006, there were eight ILCs within OTS-regulated SLHC structures. These ILCs had aggregate assets of $142 billion or almost 67 percent of all ILC assets. In fact, six of the ten largest ILCs are owned or controlled by OTS-regulated SLHC structures. These six ILCs hold aggregate assets of $138 billion, accounting for roughly 73 percent of the assets of the ten largest ILCs.[2] And of the top 15 ILCs,[3] the OTS regulates SLHCs that own or control eight. These eight institutions hold assets of $142 billion, representing 71 percent of the assets of the 15 largest ILCs. The OTS is an active holding company supervisor of these eight institutions.

Pursuant to the Home Owners' Loan Act (HOLA), when a company controls both a savings association and an ILC, not only is the SLHC itself subject to OTS examination, so is the ILC. Although the HOLA excepts "banks" from OTS SLHC examination authority, the HOLA defines banks with respect to the BHCA. Since ILCs are not banks for purposes of the BHCA, ILCs controlled by SLHCs are subject to OTS examination. As detailed below, OTS supervision of SLHCs, including SLHC parents of ILCs, is statutory, comprehensive, risk-focused, and inclusive of the views of all relevant functional supervisors.

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2. The ten largest ILCs held assets of almost $190 billion, accounting for approximately 89 percent of aggregate ILC industry assets.

In connection with OTS oversight of SLHCs that own ILCs, the OTS is able to participate in examinations of the ILC by the state regulatory authority and/or the FDIC. The OTS determines its level of participation in consultation with each ILC's relevant functional supervisor on a case-by-case basis. In each case, our goal is to ensure adequate oversight and coordination, while creating minimal regulatory overlap. Similarly, we coordinate our oversight and examinations of SLHCs to ensure that examiners exchange adequate and sufficient information with applicable state and/or FDIC staff and, when appropriate, other functional regulators.

IV. OTS Authority and Supervision of SLHCs

The OTS supervises a diverse population of holding companies. These range from non-complex companies with limited activities to large, internationally active conglomerates that engage in numerous, diverse activities and an array of domestic and international transactions. In connection with our strong statutory oversight and supervision of SLHCs and their subsidiary savings institutions, we have a well-established supervisory program for discharging the responsibilities assigned to us by law. Holding company supervision is an integral part of this oversight program and enables us to ensure risk-focused oversight of the entities that own or control licensed thrift institutions.

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3. The 15 largest ILCs held assets of $201 billion, accounting for approximately 94 percent of aggregate ILC industry assets.

The OTS's holding company oversight program appropriately balances the need for effective supervision with the interests of a holding company enterprise to avoid excessive regulatory intrusion in its affairs. We focus on the company's capital and earnings, risk management framework, and governance structure. We evaluate the oversight provided by the board of directors, and the effectiveness of holding company management at all levels. We also continually review key risk control functions, such as the enterprise's risk management framework, the internal audit function and the major risk concentrations and transactions that occur within the consolidated entity.

Our program is designed to understand how the company conducts business and manages risk throughout the enterprise. This understanding allows us to accurately assess the financial condition and risk profile of the holding company enterprise. It also enables us to consider the impact of the enterprise on insured depository subsidiaries or other regulated financial companies within the structure. Our program is designed to provide constructive and substantive feedback on these critical issues to boards of directors and management.

As noted above, OTS's authority as the primary supervisor of consolidated SLHCs is set forth in the HOLA. Pursuant to this authority, any company that proposes to acquire a thrift, and thereby become a SLHC, is subject to a statutory licensing (authorization) process that requires us to make numerous statutory findings.

In addition, the OTS has full legal, examination, and enforcement powers over savings associations, SLHCs, thrift subsidiaries, and third-party contractors performing services for, or conducting activities on behalf of, any of these entities. In particular, the HOLA provides that SLHCs and each subsidiary thereof (other than a bank) are subject to OTS examination.[4] This authority includes the ability to examine and oversee any activity or entity in a SLHC structure, as well as to take enforcement action when appropriate.

In exercising its statutory oversight authority, the OTS works cooperatively with sectoral and functional regulators, including other federal and state banking agencies, as well as state insurance and federal securities supervisors. We also coordinate with various international financial supervisors on the supervision and oversight of internationally active SLHCs and their affiliates and subsidiaries. Due to our extensive communication and coordination with other supervisory agencies, we have information sharing, coordination, and confidentiality agreements with more than 60 domestic and international supervisors.

In addition, our supervisory program has achieved equivalency status from the European Union for three firms – an industrial conglomerate, a global insurance firm, and an international securities firm. The OTS's status as a consolidated supervisor

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[4] The Gramm-Leach-Bliley Act imposed certain limitations on the OTS's ability to examine functionally regulated subsidiaries.

necessitates extensive contact with the domestic and international supervisory community for these and other internationally active complex firms supervised by the OTS.

In carrying out its statutory holding company authority, the OTS conducts an extensive supervisory program. SLHCs are subject to reporting and examination requirements defined by the OTS. In this regard, we tailor information requests and examinations to address the specific issues and risks at an institution and/or a SLHC. Examiners conduct holding company examinations concurrently with the statutorily mandated schedule for annual (or 18-month) examinations of thrifts.

The OTS also follows a continuous supervision program at the largest and most complex thrifts and SLHCs. This continuous supervisory program includes developing a risk assessment, a supervisory plan, and conducting targeted reviews of high-risk areas. We also coordinate with functional regulators, and routinely meeting with senior management and the boards of directors of the thrift or SLHC and its subsidiary organizations.

The OTS follows a risk-focused, top-down examination approach at all SLHCs. It analyzes the parent holding company and material subsidiaries for their impact on the SLHC structure. There is particular scrutiny on the extent of any direct and/or indirect adverse finding that may affect the subsidiary thrift institution. This includes a review of intra-group transactions and risk concentrations in order to assess material transactions

between affiliated entities. We also determine which business lines present the greatest potential risk to the SLHC, on a consolidated basis, and its subsidiary savings association.

Our holding company procedures are centered on an enterprise-wide assessment of the Capital, Organization Structure, Relationship, and Earnings/Liquidity of the holding company structure. This "CORE" examination approach is designed for understanding, analyzing, and evaluating a firm's risk appetite and its approach to risk management. The more complex the firm, the more comprehensive our review and assessment of its risk profile and the effectiveness of its risk control functions.

The OTS works to reduce regulatory burden and redundant supervision by working cooperatively with other functional supervisors (e.g., the FDIC, Utah State Banking Department, Securities and Exchange Commission, etc). For example, we obtain copies of examination reports for material subsidiaries. Other examples of our coordination with other supervisors include:

- Hosting annual supervisors' meetings on financial conglomerates for all supervisors with material business subsidiaries in the conglomerate to discuss common trends, findings, or violations.
- Routine communications with the FDIC and state bank supervisors regarding ILCs within SLHC structures. In this regard, the OTS relies on the expertise and examinations of these functional regulators, rather than conducting its own examination of each material entity. If there is a material problem

emerging within an ILC that could affect the holding company enterprise, the OTS works closely with the functional regulator to minimize the impact on the enterprise and/or the OTS-regulated thrift subsidiary.

- Cooperating extensively with the FDIC and the State of Utah on several information technology examinations of SLHCs with ILC subsidiaries. In connection with these exams, each regulator appointed a central point of contact for each firm, with quarterly meetings to discuss examination strategy and planning.
- Obtaining and reviewing copies of SEC filings, audit reports, rating agency reports, and internal management reports (all of which generally include analysis of the ILC subsidiary if it is a material portion of the enterprise).
- Obtaining the most recent examination reports for an ILC when the OTS conducts a holding company examination. When the ILC reports indicate a significant weakness or concern, we follow up with the primary regulator. If the examination reports do not reveal any concerns, we incorporate the review and findings as part of its risk-focused examination approach.

Finally, the Government Accountability Office (GAO) confirms that the OTS has a strong and internationally recognized consolidated holding company supervision regime. We have worked hard in recent years to ensure that this program is up to the task of supervising the complex and internationally active SLHCs subject to our oversight.

Among the factors stressed by the GAO with respect to consolidated supervisory oversight is the importance of interagency collaboration. As noted above, this is an area in which the OTS is particularly aggressive, with outreach to both domestic and international supervisors to ensure the agency can incorporate the views of all functional regulators into its examination reports.

OTS's consolidated holding company oversight program is a viable model for SLHCs with diverse and wide-ranging activities and operations. It is a model that also accommodates the various and sometimes competing interests that exist within holding companies that own or control other companies engaged in functionally regulated activities and that own or control an insured depository institution, including an ILC.

VI. Comprehensive Consolidated Supervision Standards

I also want to address a provision currently being discussed as an amendment to H.R. 698. This provision would provide that if any foreign bank acquires an ILC, the Board of Governors of the Federal Reserve System (FRB) would make a determination, in consultation with the FDIC, that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in the bank's home country.

The OTS believes it is appropriate to include a comprehensive consolidated supervision (CCS) standard in connection with a foreign bank's acquisition of an

industrial bank. The BHCA imposes a CCS standard in connection with the FRB's review of an acquisition of a bank (as defined in the BHCA) by a foreign bank. Similarly, the HOLA requires that OTS make a CCS determination whenever a foreign bank proposes to acquire a savings association.[5] While we support a new CCS determination for a foreign bank that is an existing depository holding company, if the holding company is a SLHC then the OTS is the appropriate regulator to make the CCS determination. In such a case, the foreign bank/SLHC is already subject to OTS supervision, and OTS is already coordinating with foreign supervisors in connection with its supervision of the holding company. Given that OTS made the previous CCS determination with respect to the foreign bank, and OTS regulates – and will continue to regulate -- the foreign bank as an SLHC, the OTS believes that it, and not the FRB, should make the CCS determination in these cases.[6]

The OTS has the requisite expertise to make the CCS determination. OTS has been required to make CCS determinations regarding acquisitions of thrifts by foreign banks since 1991.[7]

In implementing the CCS approval standard, OTS regulations[8] provide that OTS will consider the same standards that the FRB applies in making CCS determinations.[9]

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[5] Section 10(e)(2)(D) of the HOLA, 12 U.S.C. § 1467a(e)(2)(D).

[6] Such a result is consistent with section 10(e)(2)(D) of the HOLA, which requires a separate CCS determination be made each time a foreign bank acquires a savings association.

[7] The approval standard relating to CCS was imposed by section 221 of the Federal Deposit Insurance Corporation Improvement Act of 1991, P.L. 102-242 (Dec. 19, 1991).

Under these standards, the relevant issues regarding a CCS determination relate to the nature of the foreign bank's supervision, and are not dependent on the charter of the target U.S. depository institution.

One of the underlying purposes of the GLB Act, and various prior laws such as EGRPRA, was to reduce regulatory duplication. In a case involving an acquisition of an ILC by a foreign bank that is already a SLHC, the OTS is, and will continue to be, the consolidated regulator of the holding company structure. FRB participation in the process would add a layer of regulatory duplication with no discernable policy benefit.

If a foreign bank/SLHC pursues an acquisition of a bank or establishment of a branch in the United States, the resulting entity would be a BHC. In such instances, it is entirely appropriate for the FRB, as the resulting HC regulator, to conduct the CCS review. However, a situation involving a SLHC and an ILC is distinguishable. In the former cases, the FRB will have ongoing supervisory authority with respect to the holding company structure after the acquisition of the bank (or establishment of the bank branch). Where a foreign bank/SLHC acquires an ILC, the FRB will not have any ongoing supervisory authority after the transaction. In contrast, OTS will have had, and will retain, ongoing supervisory authority over the holding company structure. Thus, we believe that where the existing and resulting HC is a SLHC, the OTS is the appropriate U.S. regulator for the CCS determination.

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[8] 12 C.F.R. § 574.7(c)(2)(iv) (2007).

[9] These standards are set forth at 12 C.F.R. § 211.24(c)(1)(ii) (2007).

VII. Conclusion

The OTS has extensive experience overseeing SLHCs, including financial conglomerates and commercial holding company structures. The agency evaluates the consolidated holding company structure as well as the relationship between the insured depository institution and its affiliates. OTS supervision provides a strong and robust regulatory framework that oversees a SLHC's risk management platform, rather than dictating the course of conduct of the affairs and operations of the holding company. This approach ensures the flexibility these firms require to compete in a dynamic marketplace while providing a strong supervisory structure over their policies, procedures and activities.

We support Congressional efforts to address concerns with respect to the oversight of ILC holding company parents, recognizing that OTS currently exercises effective supervision of SLHCs that control approximately 67 percent of ILC industry assets nationwide. As currently drafted, H.R. 698 preserves existing OTS authority and oversight of these SLHCs that own or control ILCs; promotes functional regulation while promoting consolidated regulatory oversight of holding companies; and maintains a forward-looking, risk-based focus to oversee holding companies that own or control institutions with access to the federal safety net. For all these reasons, the OTS supports H.R. 698 as introduced by Chairman Frank, Congressman Gillmor, and the other Sponsors on the Committee. Thank you.

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HEARING BEFORE THE

HOUSE FINANCIAL SERVICES COMMITTEE

ENTITLED

H.R. 698
THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

WRITTEN TESTIMONY OF
THOMAS M. STEVENS, CRB, CRS, GRI
2007 IMMEDIATE PAST PRESIDENT

NATIONAL ASSOCIATION OF REALTORS®
APRIL 25, 2007

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.

Chairman Frank, Representative Bachus and Members of the Committee, thank you for inviting me to testify today on H.R. 698, the "Industrial Bank Holding Company Act of 2007." My name is Tom Stevens, and I am the 2007 Immediate Past President of National Association of REALTORS®. I am also the former President of Coldwell Banker Stevens (now known as Coldwell Banker Residential Brokerage Mid-Atlantic) – a full-service realty firm specializing in residential sales and brokerage.

I am here to testify on behalf of our more than 1.3 million REALTOR® members who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors and others engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS®. We commend the committee for holding today's hearing on the issue of closing the ILC loophole and restoring the traditional separation between banking and commerce. We would also like to thank Representative Gillmor for his dedication to pursuing a legislative solution to this important issue, which began more than four years ago.

NAR Opposes Commercial Firms Owning Banks

NAR is extremely concerned about both Home Depot's and other commercial companies' intention to acquire industrial loan companies (ILCs) chartered by the state of Utah. NAR is on record as opposing Home Depot's Notice of Change in Control related to its proposed acquisition of the ILC, EnerBank USA, as well as Wal-Mart's now withdrawn application for federal deposit insurance for Wal-Mart Bank.[1] Detailed below are our specific concerns regarding Home Depot's application and general concerns about commercial companies owning ILCs.

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[1] Federal Deposit Insurance Corporation (FDIC) Public Hearings Regarding the Deposit Insurance Application of Wal-Mart Bank, Testimony of Thomas M. Stevens, CRB, CRS, GRI, President, National Association of REALTORS® (April 11, 2006); 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); and Statement of the National Association of REALTORS® before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit for the hearing entitled, "ILCs—A Review of Charter, Ownership, and Supervision Issues" (July 12, 2006).

NAR believes that banks should provide financial services on an arms-length basis 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.

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 ILCs 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 an ILC 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 urges the House Financial Services Committee to pass H.R. 698, the "Industrial Bank Holding Company Act of 2007," and eliminate the ILC loophole that permits commercial firms to own this type of federally insured state bank.

Home Depot "Bank" – ILC

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

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 an ILC 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; an ILC 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 that will arise because the commercially-owned ILC may not have the freedom to exercise the discipline needed to make truly independent credit judgments.

Unlike other commercial ILC applicants whose stated purpose is very narrow, e.g. auto loans, 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.[2] 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 resources of The Home Depot will also strengthen the high level of service we offer to our existing contractors and program sponsors."[3]

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. The notice Home Depot filed with the FDIC 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

[2] News Release, *The Home Depot to Acquire EnerBank USA*, http://ir.homedepot.com/ReleaseDetail.cfm?ReleaseID=195724.
[3] *Id.*

contractor customers, and as a result, they will be more likely to purchase their materials from The Home Depot.[4]

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 uneven competitive playing field is also 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. Part 223, which limit "transactions with affiliates." EnerBank, of course, is subject to the restrictions of Section 23A and Regulation W.[5] 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 Home Depot's Notice of Change in Control 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.[6] 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 miscomprehension of banking law.

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[4] Interagency Notice of Change in Control filed by Home Depot on May 8, 2006, page 10.
[5] 12 U.S.C. 1828(j).
[6] Notice at page 10.

NAR has recommended that the FDIC consult with the Federal Reserve, the agency with rulemaking and interpretive authority for Section 23A[7], 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 Home Depot "Bank" is flawed and accordingly, we oppose its Interagency Notice of Change in Control filed with the FDIC. As NAR has consistently stated over the years, we believe Congress, not the regulators should decide whether it is appropriate to permit the mixing of banking and commerce. Unless Congress acts on H.R. 698, the ILC loophole will remain intact and ripe for future ILC approvals by the FDIC.

Commercially-owned "Banks" – ILC

Wal-Mart's withdrawal of its application to open an ILC does not change our position that Congress should pass H.R. 698 and close the ILC loophole. We remain committed to the position that any commercial company's effort to obtain a federally-insured depository institution 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.

Conflict of Interest

While some commercial companies have applications for ILCs for very limited purposes, such as auto loans or credit cards, the fact remains that most applicants have not proposed a limitation to preclude the ILC from significantly expanding the bank's deposit taking activities at any time. Some of the significant risks we have raised will undoubtedly come to fruition if large commercially-owned ILCs are able to compete with other depository institutions in accepting deposits.

[7] 12 U.S.C. 371c(f).

For example, a commercially-owned ILC could divert the funds raised investments in securities rather than to loans to residents and businesses in the communities in which it raised the funds. The impact would be a diversion of funds that would have otherwise been lent locally through community banks and thrifts. These risks would be exacerbated if the commercially-owned ILC were to engage at some future time in mortgage lending activities. Moreover, we do not believe that requiring the ILC 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 should provide financial services on an arms-length basis 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. While there are existing restrictions on transactions between a bank and its affiliates, as evidenced by the Home Depot proposal, we think that the ILC's commercial parent will inevitably use the ILC 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. Therefore, 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. We cannot afford to open the door to actions that threaten the safety and soundness of the banking system.

If a large commercially-owned ILC were to expand its business plan into retail banking, it is reasonable to expect that it would use the financial resources of its parent to attempt to dominate certain markets. If a mega-retail or large commercially-owned ILC becomes the main or only provider of financial services in a market, it would place other commercial competitors at a serious disadvantage in seeking financial services. The ILC would have a strong incentive to base its credit decisions on whether the applicant competes with the ILC's parent. Furthermore, the commercially-owned ILC could position itself to provide loans on favorable terms to the suppliers of retail stores or automobile dealers, which would put commercial firms that are not affiliated with the ILC at a competitive disadvantage.

Risk to the Stability of the Financial System

Federal Reserve Board Chairman Ben Bernanke has reaffirmed statements made his predecessor 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 a February 15, 2006, 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.

NAR believes Chairman Bernanke's statement supports the purpose and objectives of H.R. 698. We also note that closing banking loopholes is not a frequent occurrence – the last being when the Gramm-Leach-Bliley Act slammed the door on commercial firms acquiring thrifts. However, when commercial entities exploit banking loopholes and impose unnecessary risks to our financial systems, we feel it is time for Congress to say, "that's not what we intended."

A September 2005 report of the U.S. Government Accountability Office examined the risk to the Bank Insurance Fund presented by nonfinancial companies of insured industrial loan companies.[8] 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

[8] "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621 (September 2005).

by the FDIC may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company. However, 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 leave the door open to a continued mixing of banking and commerce. Given the overriding policy reasons not to permit mixing banking and commerce, the solution is to close the ILC loophole once and for all.

As was alluded to earlier, NAR is very concerned that if the commercial parent company of an ILC were ever to find itself under financial pressure, it would be tempting for it to abuse its ILC in a manner that enables it to resolve its problems. 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 a commercially-owned ILC found itself in a crisis, it would be entirely forthcoming about what is happening in communicating with its shareholders, the SEC (if publicly traded), 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 ILC or minimize harm to the rest of the financial system.

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 Home Depot's and other commercial companies' intention to acquire an ILC 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 initiatives to move in this direction.

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 each year it has blocked the agencies from issuing a final rule.

In 2005, the Office of the Comptroller of the Currency (OCC) 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 Home Depot's Notice and other commercial companies' ILC deposit insurance application, 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 Frank and Representative Bachus for holding today's hearing on H.R. 698, the "Industrial Bank Holding Company Act of 2007." NAR urges Congress to pass this important legislation, which will reinforce our national policy against mixing banking and commerce and ensure the continued stability and growth of the nation's financial system. Thank you.

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January 30, 2007

The Honorable Paul Gillmor
U.S. House of Representatives
1203 Longworth House Office Building
Washington, DC 20515

Dear Rep. Gillmor:

On behalf of the members of the American Bankers Association (ABA), I am writing to express our strong support for H.R. 698, the Industrial Bank Holding Company Act of 2007. 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, that is, an industrial loan company (ILC). ABA opposes the acquisition or chartering of banks by non-financial commercial firms. By prohibiting new commercial companies from obtaining ILCs, H.R. 698 would eliminate this mechanism for the merging of banking and commerce.

H.R. 698 would establish a number of other important regulatory guidelines with respect to ILC operations. It would establish a bright-line test regarding who may own ILCs in the future, limiting ownership to those parent companies that are truly "financial." It would create significant federal regulatory supervision of ILC parent company operations, broadly empowering the Federal Deposit Insurance Corporation (FDIC) to act in this area. The bill would establish 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.

These provisions are 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.

These provisions are important clarifications to existing law that, consistent with previous Congressional actions separating banking and commerce, appropriately resolve regulatory concerns while recognizing the interests of those who are currently lawfully engaged in ILC operations.

ABA strongly supports H.R. 698, appreciates your leadership in this area, and pledges to work aggressively in support of the bill's quick passage.

Sincerely,

Floyd E. Stoner

Floyd E. Stoner

January 29, 2007

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 strong support for H.R. 698, "The Industrial Bank Holding Company Act of 2007." This legislation will establish statutory requirements for certain state chartered industrial loan companies 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 and will bring parity to the banking system while reducing 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," addresses this issue through a common sense system of regulation for ILCs. It creates an ILC holding company structure for those ILC's not currently in a financial or thrift holding company and importantly provides the FDIC with the authority to examine the ILC holding company for safety and soundness.

In addition, your legislation allows those ILCs that have already been lawfully created to retain their current structure with the important addition of holding company supervision from the FDIC, and 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

Diane Casey-Landry

Diane Casey-Landry
President and Chief Executive Officer

cc: The Honorable Spencer Bachus

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Immediate Past Chairman

CAMDEN R. FINE
President and CEO

February 1, 2007

Honorable Barney Frank
Chairman
Committee on Financial Services
U. S. House of Representatives
Washington, D.C. 20515

Honorable Paul Gillmor
Ranking Member
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U. S. House of Representatives
Washington, D.C. 20515

Dear Chairman Frank and Ranking Member Gillmor:

The Independent Community Bankers of America (ICBA), representing 5,000 community financial institutions across the nation, strongly endorses your legislation, the Industrial Bank Holding Company Act of 2007 (HR 698), and urges its immediate adoption. Thank you for your leadership on this critical issue.

The separation of banking and commerce is one of the pillars of our economic system and has helped make it the envy of the world. Keeping banks and commercial firms separate ensures the impartial allocation of credit, avoids excessive concentration of economic power, and protects American taxpayers against an unwarranted extension of the federal safety net.

Your legislation would ensure that this doctrine is maintained by closing the last remaining loophole in the law that permits commercial firms to own financial institutions, the industrial loan company (ILC) loophole. HR 698 would prohibit commercial firms from chartering or acquiring industrial banks after January 28, 2007, and promote the stability of our financial system and the Deposit Insurance Fund by bringing all ILCs and their parent companies under enhanced regulation and supervision by the FDIC. It also would impose branching and activities restrictions on commercially-owned industrial banks chartered between October, 2003, and May 2006.

NDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks*℠
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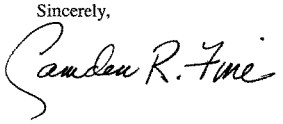
We believe this is a common sense and balanced approach that does no harm to existing ILCs while protecting taxpayers against catastrophic losses that could be incurred by a failure of a corporate conglomerate owner of an ILC.

The public policy implications of this issue are too important and far reaching to be determined on parochial or regional grounds. The FDIC board voted unanimously to extend the moratorium on ILC applications filed by commercial firms for the purpose of giving Congress a reasonable interval in which to act. We must stop the mixing of banking and commerce before it irrevocably changes our financial landscape, as it did in Japan which experienced a 15 year recession. That is why ICBA and our 5,000 member banks nationwide strongly endorse HR 968 and urge its immediate adoption.

Sincerely,



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March 20, 2007

The Honorable Paul E. Gillmor
U.S. House of Representatives
1203 Longworth House Office Building
Washington, D.C. 20515-3505

Dear Representative Gillmor:

I am writing on behalf of over 1.3 million members of the National Association of REALTORS® to convey our support for H.R. 698, "The Industrial Bank Holding Company Act of 2007," which, as you know, enhances regulation of the parent companies of industrial banks and restores the traditional separation between banking and commerce.

Despite Wal-Mart's recent announcement to withdraw its application to charter an industrial loan company (ILC), there are still a number of commercial companies pursuing ILC ownership, including Home Depot. As NAR has written, testified and continued to discuss, mixing banking and commerce puts our national economy at risk. NAR maintains that when commercial firms are allowed to engage in banking, the bank functions under an inherent conflict of interest. This conflict imposes unnecessary risks to the financial systems of the bank, the parent corporation, and the national economy.

NAR believes it is time to close the ILC loophole and supports the approach taken by H.R. 698 to prohibit any additional commercial firm that generates at least 15 percent of their annual gross revenues from non-financial activities from directly or indirectly controlling an industrial bank. NAR also supports strong oversight and additional regulation for existing ILCs.

NAR stands ready to work with you and Chairman Frank to pass H.R. 698, "The Industrial Bank Holding Company Act of 2007," which will reinforce our national policy against mixing banking and commerce and ensure the continued stability and growth of the nation's financial system.

Sincerely,

Pat Vredevoogd Combs

cc: The Honorable Barney Frank

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EQUAL HOUSING OPPORTUNITY

Sound Banking Coalition

March 21, 2007

Honorable Paul Gillmor
United State House of Representatives
1203 Longworth House Office Building
Washington, DC 20515

Honorable Barney Frank
United State House of Representatives
2252 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Gillmor and Chairman Frank:

The undersigned members of the Sound Banking Coalition – 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 – strongly support the Industrial Bank Holding Company Act of 2007. The bill takes a common-sense approach to addressing the huge growth of industrial loan companies (ILCs) and the real threat posed to the safety and soundness of the financial system when these institutions are controlled by commercial entities.

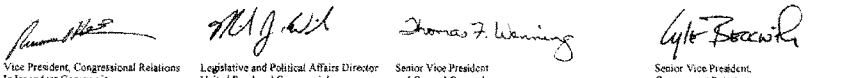
The lack of consolidated supervision of ILCs and the mixing of banking and commerce that occurs when a commercial entity owns a bank threaten some of the basic underpinnings of banking regulation in the United States and could have a significant impact on SBC members, consumers, and the financial services marketplace as a whole. All bank holding companies are subject to consolidated holding company supervision to ensure that the holding company and its subsidiaries do not create solvency risks for the bank and to ensure that the holding company can be a source of strength for the bank. ILC holding companies are not subject to any such oversight, depriving ILCs of the basic protections afforded other banks and leaving the federal deposit guaranty funds susceptible to the vagaries of the commercial marketplace.

The other key concept – the mixing of banking and commerce – is also tremendously important here. Banks are supposed to be neutral arbiters of credit and capital. When banks are owned by commercial entities, however, conflicts of interest can skew loan decisions and lead to systemic problems. This is not just a philosophical exercise. Japan provides an explicit example of the dangers of mixing commerce and banking.

Your proposed legislation ably addresses these issues. By limiting the amount of commercial activity in which an ILC holding company may engage, the bill greatly reduces the threats posed by the banking/commerce mix, and by bolstering the FDIC's supervisory authority over ILC holding companies, the bill strengthens consumer protections and reduces threats to the financial system.

Thank you for your efforts to address the problems created by the ILC loophole and for introducing the Industrial Bank Holding Company Act. We look forward to working with you to enact of this important legislation.

Sincerely,



Vice President, Congressional Relations
Independent Community
Bankers of America

Legislative and Political Affairs Director
United Food and Commercial
Workers International Union

Senior Vice President
and General Counsel
National Grocers Association

Senior Vice President,
Government Relations
National Association of Convenience Stores

STATEMENT OF THOMAS J. BLILEY, JR.

on behalf of

THE SOUND BANKING COALITION

THE HOUSE FINANCIAL FINANCIAL SERVIES COMMITTEE

H.R. 698, THE INDUSTRIAL BANK HOLDING COMPANY ACT OF 2007

April 25, 2007

This statement is submitted on behalf of the Sound Banking Coalition (the Coalition) in connection with the House Financial Services Committee's hearing on H.R. 698, The Industrial Bank Holding Company Act of 2007. We appreciate the opportunity to submit this statement and thank Chairman Frank, Ranking Member Bachus and the members of the Committee for holding a hearing on this important issue. In addition, we would like to thank Representative Gillmor and Chairman Frank for introducing this legislation and their work over several years to try to address this public policy problem. H.R. 698 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 goal of the Coalition has always been closing the ILC loophole. While H.R. 698 does not close the loophole entirely, it strikes a fair balance

between our policy ideal and the desires of ILC supporters. One of the things my time in Congress taught me is that compromise is necessary to get things done. Chairman Frank, Mr. Gillmor and others on this Committee have done a remarkable job of balancing the competing positions that advocates have taken on this issue and come up with a good product. I urge all of you to recognize the good balance that has been struck and to support their bill.

One other issue that I want to be sure to address is the recent withdrawal of Wal-Mart's application for an ILC. The regulation of ILCs was a fundamental public policy issue before Wal-Mart applied and remains so now. The Sound Banking Coalition formed in early 2003 – more than two years before Wal-Mart submitted its application to the FDIC. We remain committed to addressing this public policy issue and Wal-Mart's decision to withdraw its application does not change that. The problems with the ILC loophole run deeper than any one applicant and must be fixed.

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.[1] 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

[1] Industrial banks are also known as industrial loan companies (ILCs).

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.

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.[2]
- **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

[2] Letter to Senator Tim Johnson from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, June 25, 2003, at 4.

> 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.[3] 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 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

[3] *Id.* at 5.

> 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 the GMAC ILC? Without regulation by the Federal Reserve that is very hard to say. Perhaps the ILC is 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 an ILC 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 has been due to Wal-Mart's application for an ILC charter, but it also 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 passed last year ban ILC branches on the premises of a commercial affiliate and Colorado passed a similar law this year. A law in Wisconsin now prohibits ILCs from doing any business in that state. Missouri also passed legislation limiting ILCs last year. 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 law Utah enacted last year 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 settle this debate. Mr. Gillmor and Chairman Frank have provided the blueprint for doing just that and we hope the Committee acts on it promptly.

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 Sound Banking Coalition