Testimony
by
James P. Ghiglieri, Jr.
President
Alpha Community Bank
Toluca, IL
&
Chairman
Independent Community Bankers of America
Washington, DC

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 The fact that Wal-Mart has withdrawn its application to establish a federally insured ILC does not diminish the need to close this loophole.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]

---

[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 <u>no</u> 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

---

[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.

---

[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

---

[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

---

[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.
>
> * * *
>
> 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.

---

[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

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