Testimony of

Arthur C. Johnson

Chairman and Chief Executive Officer, United Bank of Michigan

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

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Mr. Chairman and members of the Subcommittee, my name is Arthur C. Johnson. I am Chairman and Chief Executive Officer of the United Bank of Michigan, headquartered in Grand Rapids, Michigan. I also serve as Chairman of the Government Relations Council of the American Bankers Association ("ABA"), and I am testifying today on behalf of the ABA. The ABA brings together all categories of financial institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA's views on the regulation of industrial loan corporations ("ILCs"). The ILC industry has changed dramatically since Congress last enacted legislation concerning the ownership of ILCs. Indeed, the seeds planted by that law have grown into a garden in severe need of tending.

In my statement today I would like to make three points:

- First, the ILC industry of today bears little resemblance to the ILC industry of 1987, the year the current ILC law was enacted.

- Second, the current regulatory approach is inconsistent with the policy of separating banking from non-financial commerce.
- Third, Congress should act to ensure that potential problems do not become real.

These points are addressed in further detail below.

I. THE ILC INDUSTRY OF TODAY BEARS LITTLE RESEMBLANCE TO THE ILC INDUSTRY OF 1987, THE YEAR THE CURRENT ILC LAW WAS ENACTED.

The current exemption from the Bank Holding Company Act for companies that own ILCs was enacted in 1987. Since that time the ILC industry has experienced explosive growth, and the assumptions upon which the exemption was predicated no longer remain valid.

ILCs began in the early 1900s to provide uncollateralized consumer loans to low- and moderate-income workers unable to obtain such loans from existing commercial banks.[1] ILCs initially were not eligible for federal deposit insurance when the FDIC was created. However, the FDIC changed its policy over time until, with passage of the Garn-St Germain Depository Institutions Act of 1982, all ILCs were granted eligibility for deposit insurance, as were the thrift certificates they offered in lieu of deposits.[2] Some states thereafter *required* ILCs to obtain FDIC insurance as a condition of chartering, with the result that by 1987, the FDIC insured most ILCs and shared supervision with their state charterers.

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[1] GAO-05-621 *Industrial Loan Companies,* September 15, 2005.
[2] Pub. L. No. 97-320 § 703.

In 1987, Congress enacted the Competitive Equality Banking Act ("CEBA"), one of the primary purposes of which was to close the "non-bank bank" loophole. Because the definition of "bank" in the Bank Holding Company Act at that time included only entities that offered commercial loans *and* accepted demand deposits, a number of large retail commercial entities acquired institutions that made loans but did not offer demand deposits. This approach enabled them to avoid supervision as bank holding companies while offering banking services on an interstate basis.

When Congress amended the definition of "bank" in the Bank Holding Company Act to eliminate the non-bank bank loophole, it also provided an exemption from that definition for certain ILCs that:

1) do not accept demand deposits that can be withdrawn by check or similar means for payment to third parties;
2) have total assets of less than $100 million; or
3) have not undergone a change in control after 1987.[3]

The exemption applied to a comparatively few, small institutions. In 1987, most ILCs had less than $50 million in assets. The few states that were able to charter ILCs were not promoting the charter. In fact, Utah had a moratorium at the time on the creation of new ILCs. In short, there was no significant risk that problems caused by mixing banking and non-financial commerce would arise from the ILCs that existed at the time that the exemption was codified.

[3] The exemption applies only to ILCs chartered in states that in 1987 required ILCs to have deposit insurance, namely, California, Colorado, Hawaii, Minnesota, Nevada and Utah.

Almost twenty years later, the characteristics of ILCs have changed dramatically. Between 1987 and the first quarter of 2006, aggregate ILC assets have grown almost 4,000 percent, from $3.8 billion to over $155 billion, with the average ILC holding close to $2.6 billion in assets. According to a 2005 report by the Government Accountability Office (GAO), only seven states have active ILCs, and California, Nevada, and Utah charter more than half, with the state of Utah leading in ILC asset growth.[4] There are a total 60 ILCs to date with another 13 applications for federal deposit insurance pending.

This growth is not by accident. In 1997, Utah lifted its moratorium on new charters, permitted ILCs to call themselves "banks," and authorized them to engage in virtually all of the powers of state-chartered banks. Today the Utah Department of Financial Institutions touts the benefits of ILCs on its web site, stating --

> Generally, IBs [*i.e.*, industrial banks] are authorized to make all kinds of consumer and commercial loans and to accept federally insured deposits, but not demand deposits if they have total assets greater than $100 million. * * * The flexibility of an IB charter has made it an attractive vehicle for some large and well-known corporations. IBs offer a versatile depository charter for companies that are not permitted to, or that choose not to, become subject to the limitations of the Bank Holding Company Act or the Glass Steagall Act.[5]

[4] The GAO report states that "As of December 31, 2004, there were 29 ILCs, representing 82 percent of the ILC industry assets, with headquarters in Utah. According to officials at the Utah Department of Financial Institutions, ILC growth in Utah occurred because other state laws are not as 'business friendly' as Utah. These officials also stated that Utah has state usury laws that are more desirable than many other states and the state offers a large well-educated workforce for the financial institutions industry." GAO-05-621, *Industrial Loan Companies*, September 15, 2005 at 19.
[5] http://www.dfi.utah.gov/whatisIB.htm.

Today, an ILC—even one with assets in excess of the $100 million threshold codified in CEBA—may effectively compete with full-service insured depository institutions. As recently observed by Chairman Alan Greenspan, ILCs may engage in the "full range of commercial, mortgage, credit card and consumer lending activities; offer payment-related services, including Fedwire, automated clearing house and check clearing services, to affiliated and unaffiliated persons; [and] accept time and savings deposits, including certificates of deposit from any type of customer."[6]

The assumptions underlying the current system of regulating today's ILCs – namely, that they are small lenders meeting the needs of the underserved – are no longer valid. Industrial banks do not resemble the small ILC of yesteryear that was created to make uncollateralized loans to industrial workers. Instead, they are increasingly large, sophisticated commercial firms that have identified a loophole that allows them to own an insured depository institution without becoming a bank holding company.

II. THE CURRENT REGULATORY APPROACH IS INCONSISTENT WITH THE POLICY OF SEPARATING BANKING FROM NON-FINANCIAL COMMERCE.

Our banking laws historically have provided for the separation of banking and non-financial commerce to protect depository institutions, the federal deposit insurance fund, and our financial system in general from a variety of potential risks. Indeed, over the past 50 years, Congress has repeatedly acted to close avenues through which non-financial commercial entities could own depository institutions.

[6] Letter from Federal Reserve Board Chairman Alan Greenspan to Congressman James Leach dated January 20, 2006.

The Bank Holding Company Act of 1956 prohibited companies that owned two or more banks from engaging in non-financial commercial activities. In 1970, Congress extended that prohibition to companies that owned only a single bank. In 1987, Congress closed the "non-bank bank" loophole. Most recently, the Gramm-Leach-Bliley Act prohibited new non-financial commercial entities' acquisition of a single savings association.

In each of these instances, Congress looked at whether it was appropriate for companies to engage in banking while engaging in a significant way in non-financial commerce. And in each instance, Congress removed the option while giving due consideration to the equities of those holding existing investments.

The ABA has consistently supported these Congressional actions. In September of last year, our Board of Directors unanimously reaffirmed ABA's position that non-financial commercial firms should not be engaged in acquiring and chartering banks, including ILCs.

It would be odd for Congress repeatedly and consistently to close provisions that permitted non-financial commercial firms to own insured depository institutions and yet leave open an outdated provision of law that could undermine the consistent legislative steps that have prohibited the mixing of banking and commerce. Left unchecked, this regulatory approach risks systemic problems.

III. CONGRESS SHOULD ACT NOW TO ENSURE THAT POTENTIAL PROBLEMS DO NOT BECOME REAL.

There are a number of potential problems stemming from the current approach to regulating ILCs. These problems, if left unattended, have the potential to erode unalterably the separation of banking from non-financial commerce that has served our country so well.

The rationale for maintaining a separation of banking from non-financial commerce is clear. The banking industry is carefully regulated for safety and soundness and systemic risk because of the critical nature of the industry to the functioning of our economy. By contrast, non-financial firms are regulated under differing programs and for a variety of purposes. However valuable these other purposes might be, they must not be allowed to compete for attention in the executive offices or in the board room with the fundamental purposes of banking institutions.

Blending banking and non-financial commerce raises a host of issues. Among these is the potential for a conflict of interest, particularly in decisions concerning extensions of credit. A non-financial commercial firm could pressure or otherwise encourage a bank subsidiary to grant customers of the firm credit on favorable terms or refuse to grant credit or stiffen credit terms to the firm's competitors or their customers. Credit decisions based on factors other than the creditworthiness of the borrower and other relevant, customary banking considerations have the potential to threaten the safety and soundness of the bank and pose a related risk to the federal deposit insurance system, while encouraging abusive financial practices. Allocating credit in this way runs counter to the general purposes of a bank charter and its obligations to customers, and could be particularly aggravating in smaller communities.

Additional issues may arise when a bank, in order to cope with reputational risk from a non-financial parent or non-financial affiliate, might be tempted to make funding decisions to support the affiliate or its customers that are not in the best financial interests of the bank.

In short, a non-financial commercial firm, unaccustomed to operating within the heavily regulated banking environment, presents a greater risk that it will use a subsidiary bank to serve the firm's commercial purposes instead of serving as a source of strength for the bank.

The current regulatory landscape, by creating incentives to obtain a bank through an ILC charter, increases the likelihood that these risks will become problems. Non-financial commercial firms that own ILCs are outside the consolidated supervision of a bank regulator. And they are not subject to bank capital requirements. These competitive advantages may have been tolerable when CEBA was passed, but today they are not.

The most effective way to remedy the current situation is to limit ownership of insured depository institutions to companies that are financial in nature. Thus, the ABA recommends that Congress close the ILC loophole by requiring any company that seeks to establish or acquire an ILC be a financial firm, with the determination based on a specified percentage of revenues derived from activities that are financial in nature or incidental or complementary to a financial activity.

This approach would apply to non-financial commercial firms that currently own an ILC but that in all likelihood could not meet a test based on revenues derived from financial activities. The ABA recognizes that legislation affecting ILCs, like legislation that has closed previous loopholes, likely would grandfather these firms in an effort to strike a balance going forward. However, we urge Congress to bring any grandfathered institution within the jurisdiction of a federal bank regulator and vest that regulator with the full range of supervisory and enforcement tools necessary to protect the insured depository institution or its holding company.

CONCLUSION

The program governing ILCs is broken. ILCs are playing an increasingly important role in our nation's banking system, a role that was not evident when Congress created the ILC loophole. It is time to fix the law before the current approach leads to serious problems.