**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**

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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 20$^{th}$ 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 20$^{th}$ 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.