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

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Chairman and Chief Executive Officer, Central Bank and Trust of Hutchinson, Kansas
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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.

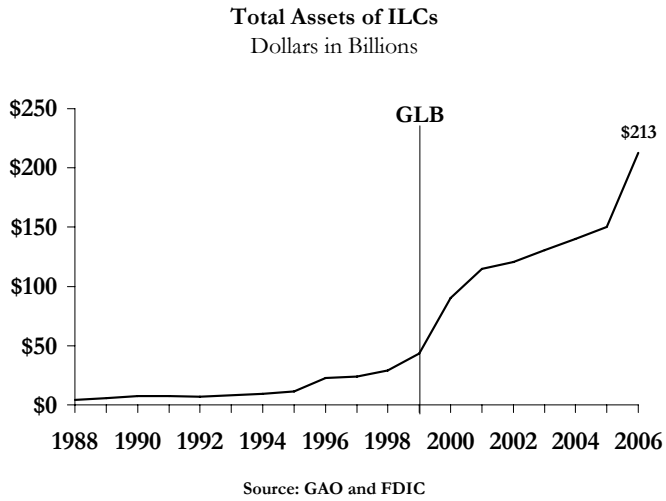
Simply put, there was no significant risk that problems caused by mixing banking and non-financial commerce would arise from the ILCs that existed at the time that the exemption was codified.

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.

[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.