NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Pat Vredevoogd Combs
ABR, CRS, GRI, PMN
President

Dale A. Stinton
CAE, CPA, CMA, RCE
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President

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Notice of Change in Control related to its proposed acquisition of the ILC, EnerBank USA, as well as Wal-Mart's now withdrawn application for federal deposit insurance for Wal-Mart Bank.[1] Detailed below are our specific concerns regarding Home Depot's application and general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.

---

[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.

---

[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.

<u>Commercially-owned "Banks" – ILC</u>

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.