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ON BEHALF OF THE SOUND BANKING COALITION**

**SENATE BANKING COMMITTEE HEARING  
“CONSIDERATION OF REGULATORY RELIEF PROPOSALS”  
MARCH 1, 2006**

I appreciate the opportunity to provide the Committee with my views of regulatory relief proposals on behalf of the Sound Banking Coalition. The Coalition’s principal concern with respect to regulatory relief is the treatment of industrial loan companies (ILCs). ILCs pose a current threat to the banking system and are already expanding a loophole in U.S. banking laws. The time has long since passed to close this loophole.

The Sound Banking Coalition (the Coalition) includes the Independent Community Bankers of America (ICBA), the National Association of Convenience Stores (NACS), the National Grocers Association (NGA), and the United Food and Commercial Workers International Union (UFCW). The Coalition’s goal is to close the ILC loophole, preserving the separation of banking and commerce in order to prevent ILCs from securing unfair competitive advantages and to protect against the threat to FDIC insurance posed by ILCs.

In 1987, Congress created a loophole in the federal banking laws that said some banks – specifically, ILCs (also called “industrial banks”) – were not banks at all for purposes of federal law. This loophole cut against a fundamental principle of U.S. banking law that has been emphasized by most states and the U.S. Congress – the separation between banking and commerce. Initially, the ILC loophole was not particularly significant because ILCs were very small, local institutions. Indeed, the regulatory exemption from holding company supervision for ILCs was based on the requirement that such charters remain small (below \$100 million in assets) *or* that they refrain from offering demand deposits that may be withdrawn by check or similar means. In the nearly 20 years since the loophole was enacted, however, industrial banks have aggressively expanded their powers and have grown to the point that deposits reach into the billions of dollars and several large corporations own and operate industrial banks. In fact, one

ILC is now among the 20 largest banks in the United States – yet it is not regulated by the Federal Reserve Board like other banks. This discrepancy in the regulatory structure creates both large competitive imbalances and risks to the safety and soundness of the banking system.

**A. FURTHER EXPANSION OF THE ILC LOOPHOLE: BAD FOR THE ECONOMY AND BAD FOR THE COUNTRY**

The Coalition believes further expansion of the ILC loophole would be bad for the economy and bad for the country. In the last Congress, the House of Representatives successfully took the first step to deal with this issue in H.R. 1375, the Financial Services Regulatory Relief bill. That legislation, enacted with strong bi-partisan support, included a crucial compromise authored by Representatives Paul Gillmor (R-OH) and Barney Frank (D-MA) limiting the ability of commercial companies to acquire and open new branches of ILCs by exploiting the ILC loophole. It should be noted that the House also included similar compromise language authored by Reps. Gillmor and Frank in the Business Checking Freedom Act of 2005, H.R. 1224, which passed the House by a vote of 424-1 last May. The current House regulatory reform measure, H.R. 3505, includes the Gillmor-Frank compromise and is on the House Union Calendar.

The Gillmor-Frank compromise is a positive first step toward closing the ILC loophole entirely. The Congress needs to take such a step in order to narrow the loophole before it becomes too large for anyone to address. Such an expansion is a very real prospect now. The largest commercial company in the nation, Wal-Mart, has applied for an ILC charter in Utah. If a company the size of Wal-Mart acquires an ILC, then the ILC loophole will, in effect, swallow the rule. Mixing banking and commerce will occur on a level that makes it – rather than the separation of banking and commerce – the norm. This is Wal-Mart's fourth attempt to acquire a bank charter and, while it currently denies that it plans to enter retail banking, the company has not been so reticent in the past. The history of these attempts to get into banking teach us that unless something is done to limit the current ILC loophole, Wal-Mart will quickly use its ILC charter to branch across state lines and open bank branches in hundreds and then thousands of its

stores. ILCs already have the power to use reciprocal branching laws to branch into more than 20 states.

The danger is not just with Wal-Mart, but with all ILCs – particularly commercially owned ILCs. Once businesses begin entering retail banking and branching, competitors will have to follow suit in order to remain competitive and we will be beset by problems.

Let me give you just a brief overview of three problems that are created by the ILC loophole.

- First, expanding ILC authority would endanger local communities and businesses;
- Second, mixing banking and commerce could lead to dangerous conflicts of interest that pose risks to the banking system and to the competitive marketplace; and
- Third, expanding the authority of ILCs would threaten the safety and soundness of the banking system.

#### **1. EXPANSION OF ILC AUTHORITY WOULD ENDANGER LOCAL COMMUNITIES AND BUSINESSES**

**Commercial ILCs opening branches would endanger community banks, which are essential to the economic health of small town and rural America.** Community banks are critical for the economic well-being of cities and towns throughout the United States. Most community banks are owned and/or run by local citizens who have a real stake in their communities. These banks, many in rural areas, understand the needs of small business owners and are an important source of funds for small, local businesses.

Further expansion of ILC powers would, as Federal Reserve Governor Mark Olsen has said, further blur the distinction between traditional banks and ILCs. Because of their preferential regulatory treatment and their commercial interests, ILCs would have a competitive advantage over traditional banks. This would undoubtedly mean that some communities would lose their banks. This would take capital away from local communities and instead send it to far-

off ILC behemoths – leaving these smaller communities without the ability to fund new entrepreneurs and invigorate their economies. Once the community banks are run off, the commercially owned ILCs may even abandon convenient locations and leave many residents with the difficulty they face now as they drive for hours to purchase basic retail and grocery items.

Loss of community banks would not only harm individual consumers, but could directly harm local businesses by forcing them to seek banking services from their competitors. To the extent ILCs are reluctant to grant loans to competitors of their parent companies, local businesses – especially those in smaller communities – could see their access to capital dry up. Alternatively, this conflict of interest could lead local retailers to adjust their business plans to reduce the ways in which they compete with the ILC’s owner in order to secure the financing they need. This would harm not only the small businesses, but the local economy and, ultimately, individual consumers.

While some have argued that community banks and local businesses are just afraid of competition, the bottom line is that unfair competition is not healthy for our economy or our people – even if it includes the word “competition” in it.

## **2. MIXING BANKING AND COMMERCE COULD LEAD TO DANGEROUS CONFLICTS OF INTEREST THAT POSE RISKS TO THE BANKING SYSTEM AND TO THE COMPETITIVE MARKETPLACE**

**Mixing commerce and banking leads to conflicts of interest.** In the U.S. system, banks are meant to be neutral arbiters of capital. They lend based on economic fundamentals, leading to more efficient economic development. Allowing a commercial company to own and operate a bank risks skewing that role. The temptation for an entity active in the commercial marketplace to withhold loans from its competitors and steer funds toward firms with which it does business is likely to be overwhelming. That conflict of interest would threaten – not enhance – commercial competition in the marketplace in which such a bank would operate.

That is one of the primary reasons Congress traditionally drew a line between banking and commerce – a line that has been upheld by Republicans and Democrats alike. Indeed, that line was reinforced with the enactment of the Gramm Leach Bliley Act (GLBA) in 1999. GLBA recognized the interrelationship between banking and other financial services and strengthened the line of separation between banking and commerce by ending the unitary thrift loophole, which had previously allowed commercial firms to get into banking.

**Expanding a regulatory loophole in the banking laws is especially unwise in the post-Enron era.** Events have proven that even large, seemingly sound companies can be at risk. We have seen the problems faced by commercial businesses such as Enron, Worldcom and others that have been decimated by accounting scandals. All of these commercial businesses looked financially strong and reported good results to investors. Now we know the truth about them.

**We all would have paid if these commercial companies had owned banks.** The losses of these companies have been difficult for employees, investors, creditors and the economy, but what if they had owned banks? What would happen to people and small businesses who had entrusted their money to the bank? The answer is that some of them would have lost their money and there would have been a large drag on FDIC insurance. If we are lucky this type of event would simply be unfair. If we are unlucky, this would amount to a crisis like the savings and loan crisis of the 1980s.

### **3. EXPANDING THE AUTHORITY OF INDUSTRIAL BANKS WOULD THREATEN THE SAFETY AND SOUNDNESS OF THE BANKING SYSTEM**

**Interstate branching for ILCs would place the banking system at risk because banks face more stringent regulation than commercial businesses.** Allowing commercial businesses (including such diverse businesses as retailers, manufacturers, and technology companies) to own banks and establish branches throughout the United States through the industrial bank

loophole without sufficient regulatory oversight will put the banking system at risk. Banks and bank holding companies are very strictly regulated. Bank examiners closely analyze their books and banks must meet tough rules on the amount of capital reserves and other precautions they take. Regulation of ILCs is handled by the state banking authorities and the FDIC, but unlike state and national banks, ILCs are not subject to holding company supervision by the Federal Reserve Board. Because ILCs are not subject to the same holding company regulation as banks, there is no way to know whether a parent or sister company of an industrial bank is engaging in practices that may put the bank's deposits at risk.

The Federal Reserve Board has repeatedly expressed its concern about the safety and soundness implications of the ILC loophole and has vocally opposed its expansion. In one of his final acts as Chairman, Alan Greenspan wrote to Rep. Jim Leach (R-IA) warning of the dangers of ILCs. Greenspan wrote, "The ILC exemption is now the primary means by which commercial firms may control an FDIC-insured bank engaged in broad lending and deposit-taking activities and thereby breach the general separation of banking and commerce...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-services banks."

In recent testimony before the House Financial Services Committee, current Board Chairman Ben Bernanke echoed Greenspan's remarks. Governor Olsen has been more expansive. At a hearing before the House Financial Services Committee last September, Governor Olson testified in opposition to expanded ILC powers stating, "Allowing a commercial firm to operate a nationwide bank outside the supervisory framework established by Congress for the owners of insured banks raises significant safety and soundness concerns and creates an unlevel competitive playing field."

Although the Federal Reserve supports full interstate branching for banks on a de novo basis, according to Governor Olsen, "the Board believes Congress should *not* grant this new branching authority to industrial loan companies unless the corporate owners of these institutions

are subject to the same type of consolidated supervision and activities restrictions as the corporate owners of other full-service insured banks.” He warned that affirmatively granting ILCs the ability to open de novo branches nationwide “would significantly expand the attractiveness of the loophole and further blur any remaining distinction between ILCs and full-service banks,” a result that would be inconsistent with both the historical functions of ILCs and the terms of their special exemption in current law.

We could not agree more.

## **B. A WAL-MART ILC COULD MANIFEST ALL THESE DANGERS**

**The world’s largest retailer has applied for an ILC charter.** Concerns about the dangers of ILCs may have seemed theoretical or unlikely in the past – but no longer. Wal-Mart has applied for an ILC charter in Utah. The company claims that they want to merely process checks and credit cards, but they have tried to get a bank charter to open in-store branches before and once they get a charter they could branch into more than 20 states. The prospect of the largest retailer in the world getting into banking is a threat not only to banks, but to the entire country.

The potential for growth of “Wal-Mart bank” is enormous. Wal-Mart is the largest company in America and already has thousands of retail locations around the country. Once chartered in Utah, “Wal-Mart bank” could quickly branch into more than twenty other states under state reciprocal branching laws. Their many retail locations could be a foundation for opening “Wal-Mart bank” branches throughout these states.

Wal-Mart’s retail business has frequently been criticized for having a destructive impact on local communities and businesses. It has a pattern of entering local communities and using predatory pricing and other techniques to run all local competition out of business. Once local competition is destroyed, Wal-Mart is free to raise its prices, or even shut down its stores to open larger regional stores. There is no reason to believe that a Wal-Mart bank would not engage in the same practices and have the same effects on local banks.

The adverse effect that Wal-Mart has had on local businesses, workers, and communities in the retail industry should not be permitted to repeat itself in the banking industry. If competitor banks leave local communities or fail, surviving local businesses would be forced to go to their biggest competitor for loans and other banking services. For small, local competitors, this would be an untenable situation.

**Finally, “Wal-Mart bank” presents significant structural concerns.** The conflicts of interest inherent in the mixing of commerce and banking, and the lack of comprehensive regulatory oversight at the holding company level, pose major safety and soundness problems that could threaten the federal insurance safety net, and, indeed, the entire U.S. banking system. And Wal-Mart faces particular risks that are extremely difficult to address with regulatory oversight by the Federal Reserve. To cite just one example, Wal-Mart is exposed to substantial risk when there are fluctuations in the yuan. More than seventy percent of goods sold by Wal-Mart are made in China. In fact, Xu Jun, Wal-Mart China’s director of external affairs, has pointed out that China is Wal-Mart’s most important supplier in the world and noted, “If Wal-Mart were an individual economy, it would rank as China’s eighth-biggest trading partner, ahead of Russia, Australia and Canada.” The commercial ties between Wal-Mart and China pose particular risks now because China is loosening its artificial control of the valuation of its currency. As an ILC that does not have Federal Reserve oversight, FDIC insurance and individual customers of a Wal-Mart bank could be at substantial risk not only based on the fluctuations of foreign economies, but simply by virtue of policy decisions made by the Chinese government.

Safety and soundness concerns are exacerbated by the fact that Wal-Mart is a colossus that wields great political power as well as economic power. If Wal-Mart is granted an ILC charter, the pressure to further ease the limits restricting ILC activities will only increase.

### **C. REGULATORY REFORM MUST NOT EXPAND ILC POWERS**

Although the ultimate solution to address the dangers posed by the ILC loophole in the Bank Holding Company Act is to close loophole entirely, narrowing that loophole is a necessary first step. Inaction on this crucial issue will enable ILCs to proceed as we have warned. The status quo offers commercial companies a last chance to acquire a bank and expand into multiple states. When the Banking Committee considers regulatory reform legislation, we urge you to uphold sound banking policies for our nation by limiting the ability of commercial companies to acquire ILCs, engage in multi-state branching, and offer demand deposits.

Thank you for your consideration of our views.

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