Testimony of

Edward L. Yingling

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Banking, Housing and Urban Affairs

Of the

United States Senate

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Mr. Chairman and members of the Committee, my name is Edward L. Yingling. I am President and Chief Executive Officer of the American Bankers Association ("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 both in size and scope. We are very concerned that we have reached a point where prior decisions by Congress that were designed to maintain separation between banking and commerce would be permanently undermined.

Allowing non-financial commercial firms to engage in banking activities carries inherent risks, such as conflicts of interest and misallocation of credit. Congress has recognized these risks and has repeatedly curtailed the ability of non-financial firms to engage in banking. We urge the Congress to enact legislation that would maintain the long-standing separation between banking and commerce.

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

- The current policy toward ILCs is inconsistent with the long-standing tradition of separating 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.

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 50 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 to create 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. Expanded use of the ILC exemption threatens to undermine this consistent policy and reduce the flexibility that is central to our banking system and to our economy.

In the long run, the ability of commercial firms to own banks would profoundly change our banking system, causing it to become more concentrated and rigid.

II. The Full ILC Exemption Created By Congress in 1987 is no Longer Appropriate for the ILC Industry of Today.

The first ILCs appeared in the early 1900s when a few states began chartering them for the purpose of making loans to low- and moderate-income industrial workers. Because

[1] Senate Report 106-44 of the Committee on Banking, Housing, and Urban Affairs, April 28, 1999.

state laws at the time generally did not permit ILCs to accept deposits, they funded themselves by issuing to investors certificates of investment or indebtedness, dubbed thrift certificates. As such, ILCs were not considered banks and were not eligible for FDIC insurance or subject to state or federal banking regulations.

By 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 in order to keep their charters. 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 "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, 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 to provide uncollateralized consumer loans to 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.

[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.

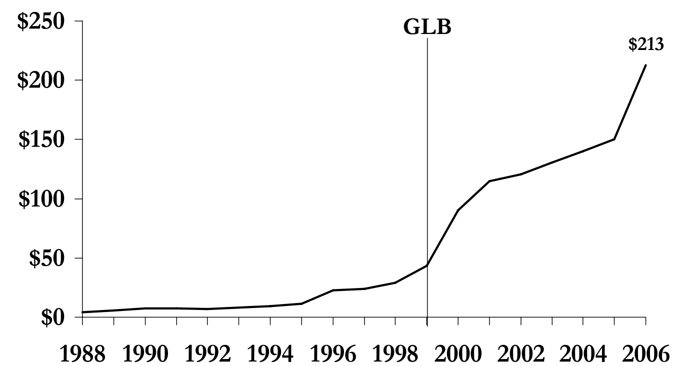
[4] GAO-05-621 *Industrial Loan Companies,* September 15, 2005.

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 June 2007, aggregate ILC assets grew more than 5,800 percent, from $3.8 billion to $225 billion, with the average ILC holding close to $3.8 billion in assets.

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 and today exceed $225 billion.

Total Assets of ILCs
Dollars in Billions



Source: GAO and FDIC

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

[5] GAO-05-621 *Industrial Loan Companies,* September 15, 2005.

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 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. Because federal law places very few restrictions on the types of activities that an ILC operating under the exemption may conduct, commercial firms wanting to engage in banking turned to ILCs as a viable option. 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 61 FDIC insured ILCs nationwide, with seven pending applications.

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

[6] FDIC Banking Review, 2004, Volume 16, No. 4 at 113.

activities nationwide, even without physical branches. As observed by former Federal Reserve 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."[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. They are increasingly large, sophisticated firms. We have a real danger that provisions of law intended for a limited purpose will be increasingly 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

In its current form, the 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.

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

Allowing banks to mix with commercial firms raises a host of issues. Among these, previously identified by Congress, is the potential for a conflict of interest, particularly in decisions concerning extensions of credit. Congress has long been concerned that a non-financial commercial firm could pressure or otherwise encourage a bank 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. This runs counter to the general purposes of a bank charter and its obligations to customers, and could be particularly aggravating in smaller communities.

Congress has also raised additional issues. For example, 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.

The recent experience in Japan, where commercial firms have been closely affiliated with banking institutions, provides a striking illustration of the inherent dangers of intermingling banking and commerce. Affiliations such as the keiretsu, where a bank and a commercial firm have substantial cross-shareholding and business ties, and the "main bank system," where a bank has extensive shareholdings in a client firm and serves as the major source of short- and long-term financing, resulted in large bank-firm relationships that dominated the Japanese economy until the latter half of the 1990s. Through such relationships the main bank typically took responsibility for monitoring the financial health of the commercial firm.

As a result, firms were insulated from the discipline that normally comes from outside directors, shareholders, and creditors. Lenders and affiliated companies were encouraged to support firms when their ability to continue as a going concern came into question. This subversion of corporate governance resulted in suboptimal business and financial decisions, exacerbating the inability of the Japanese economy to fully recover from the sharp economic downturn that began in the early 1990s.

The link to large commercial entities has important consequences for small businesses and new businesses seeking financial support. With preference given to the corporate entity (either explicitly or implicitly), credit is channeled away from smaller businesses. This becomes more acute as credit conditions tighten, as was the case throughout much of the 1990s in Japan. This means that more resources are steered to less efficient firms and away from start-ups or competing businesses that are better positioned to meet economic challenges.

The rigidity of this structure is a large part of the reason why it took so long for the Japanese economy to recover after its bubble burst in the early 1990s. In describing the genesis and solution of the severe economic crisis in Japan, Eric Rosengren (President and CEO of the Federal Reserve Bank of Boston) and Joe Peek (University of Kentucky) concluded:

> One potential source of difficulty in implementing major corporate restructuring has been the web of corporate affiliations that encourages lenders and affiliated companies to support firms that otherwise would have

> been restructured, sold, or liquidated. We show that a primary driver of lending to troubled firms has been the strength of corporate affiliations, and that lenders without such affiliations are much less inclined to allocate additional credit to deeply troubled firms. Further, as banking problems worsened in the latter half of the 1990s, evidence of lending in support of troubled affiliated firms became particularly evident.[8]

By placing relationships ahead of sound business practices that rely on credit risk analysis, Japanese banks engaged in lending policies that resulted in bank failures and massive loan charge-offs. The misallocation of credit inhibited the necessary restructuring of both banks and firms, and since small businesses did not receive the credit they needed, precluded the constant renewing of the economy that occurs through formation of new businesses. For Japanese banks, the consequences have been severe. Consider that in 1989, all of the largest global banks (by market capitalization) were headquartered in Japan. In 2006, only two Japanese banks were on that list (see the table on the following page).

The lessons from the Japanese experience were not lost on Congress. Concern over the long-term effects that result from the intermingling of banking and commerce are part of what prompted Congress to address the unitary thrift holding company issue through the Gramm-Leach-Bliley Act in 1999. Of course, we would not move to a Japanese-like system overnight. However, if the ILC issue is not addressed now, we will have set the stage for a future with a significant concentration of commercial-banking entities that would result in a much more rigid financial system.

[8] Joe Peek and Eric Rosengren, "Corporate Affiliations and the (Mis)Allocation of Credit NBER Working Paper 9643, 2002. See also "Unnatural Selection: Perverse Incentive and the Misallocation of Credit in Japan, *American Economic Review*, 2005, Volume 95, Issue 4.

Simply put, any general mixing of banking and commerce is likely to be difficult to disentangle down the road. Congress has recognized this many times before and has consistently acted to prevent the dangers that accompany it from becoming reality.

Largest Global Banks by Market Capitalization
Ranked by Market Capitalization ($ in Billions)

1989		2006	
Institution	**Country**	**Institution**	**Country**
Industrial Bank	Japan	Citigroup	United States
Sumitomo	Japan	Bank of America	United States
Dai-Ichi Kangyo	Japan	HSBC	China
Fuji	Japan	JPMorgan Chase	United States
Mitsubishi	Japan	Mitsubishi UFJ	Japan
Sanwa	Japan	Wells Fargo	United States
Nomura	Japan	UBS	Switzerland
Long Term Credit	Japan	Royal Bank of Scotland	United Kingdom
Mitsui	Japan	China Construction Bank	China
Tokai	Japan	Mizuho	Japan

Source: Morgan Stanley, Capital International Perspective

Source: The Economist

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.

CONCLUSION

The banking system that has developed in the U.S. is unique. Bankers from other countries are often surprised to hear how many banks we have and their array of sizes. This mixture provides flexibility and options for customers, is vital to the growth of our economy, and is particularly important to small businesses and new businesses. In the long run, if commercial firms were allowed to own banks our unique system could become highly concentrated and rigid.

Congress has repeatedly and consistently taken steps to maintain separation between banking and non-financial commerce. ABA urges the Senate to enact legislation that would maintain this separation. We stand ready to work with this Committee and the Congress to enact this important legislation.