October 10, 2006

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Notice and Request for Comment: Industrial Loan Companies and Industrial Banks

Dear Mr. Feldman:

The Independent Community Bankers of America commends the FDIC on its decision to impose a six-month moratorium on deposit insurance applications for new industrial loan companies and on changes of control of ILCs. This decision recognizes that pending applications are not routine applications. Granting them would have a far-reaching impact on the fundamental structure and safety and soundness of our financial and economic system and on local communities, small businesses and consumers.

ICBA also commends the FDIC, in light of the numerous significant ILC applications pending before the agency, for issuing the Notice in order to consider the regulatory, supervisory and policy issues surrounding ILCs. ICBA is pleased to respond to the FDIC's request for comment. We are also a signatory to the letter submitted to the FDIC by the Sound Banking Coalition, of which ICBA is a founding member.

The questions raised in the request highlight the key issues raised by the expansion of the ILC industry. The responses you receive will help the FDIC, as well as the Congress, decide the appropriate policy for the ownership and regulation of ILCs and their holding companies. As we have said in previous comments to the FDIC and in our testimony before Congress, it is essential that federal policy makers reaffirm our nation's long-standing policy of separating banking and commerce and ensure that any company that owns an insured depository institution be subject to consolidated supervision.

While the FDIC could take steps to enhance its supervision of the ILC industry, Congress will have to step in to achieve these results as the FDIC's regulatory authority vis-a-vis ILCs and their parent companies is limited. Therefore, we strongly urge the FDIC extend its moratorium beyond January 31, 2007, so that the new Congress will have the opportunity to review the agencies' findings on this matter and to act on the issue.

Congress has already exhibited substantial interest in the ILC issue as evidenced by a hearing held earlier this year in the House Financial Services Committee, and legislation co-sponsored by nearly 60 members of Congress that would prohibit commercial firm ownership of ILCs and enhance federal supervision of ILC parent companies (H.R. 5746, Industrial Bank Holding Company Act of 2006 and H.R. 3882, Financial Safety and Equity Act of 2005).

In addition, we urge the FDIC to hold a public hearing to gather additional public input on the ILC supervision and ownership issues. Just as the FDIC's public hearings on the Wal-Mart ILC application in April 2006 provided a mechanism for more robust public input, so would a public hearing on the overall issues surrounding ILCs aid careful deliberation by the FDIC and the Congress on the matter.

Finally, we urge the FDIC to support legislation that will prohibit commercial ownership of ILCs and provide for comprehensive, consolidated regulation of ILCs and their parent companies. An obscure exception or loophole in the law should not become a vehicle through which the financial and economic landscape of our nation is rearranged, or to create a parallel banking system with different rules and regulations than those that govern the "regular" banking system.

As requested, our comments are arranged in the order of the questions presented by the FDIC in its Notice dated August 17, 2006.

> *1. Have developments in the ILC industry in recent years altered the relative risk profile of ILCs compared to other insured depository institutions? What specific effects have there been on the ILC industry, safety and soundness, risks to the Deposit Insurance Fund, and other insured depository institutions? What modifications, if any, to its supervisory programs or regulations should the FDIC consider in light of the evolution of the ILC industry?*

The ILC industry today bears little resemblance to the ILC model in existence when the ILC loophole was created in 1987. In a January 20, 2006, letter to Rep. James A. Leach, then-Federal Reserve Board Chairman Alan Greenspan said: "The character, powers and ownership of ILCs have changed materially since Congress first enacted the ILC exemption."[1]

Industrial banks were originally small, locally owned institutions that were exempt from the Bank Holding Company Act (BHCA) because they had limited deposit taking and lending powers. However, since 1987, industrial bank activities have expanded and their assets have grown more than 3,500 percent (one has more than $58 billion in assets and $50 billion in deposits) and are owned today by some of the nation's largest commercial companies, including General Motors, General Electric and BMW.

The drafters of the ILC exemption could not have envisioned how the industry would change in the course of a few years. Indeed, in testimony earlier this year before the FDIC,

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[1] Letter from Federal Reserve Chairman Alan Greenspan to Rep. James A. Leach, January 20, 2006 ("Greenspan Letter"), p.1.

former Senator and Banking Committee Chairman Jake Garn (R-Utah) discussed the Competitive Equality Banking Act of 1987 (CEBA) that permitted certain states to continue to charter FDIC-insured ILCs that are exempt from the BHCA. He told the FDIC that, "it was never my intent, as the author of this particular section, that any of these industrial banks be involved in retail operations."

In fact, it was in CEBA that Congress closed the nonbank bank loophole to preserve the separation of banking and commerce. It certainly would have been inconsistent had Congress closed that loophole while intending to leave a similar one wide open.

In his letter earlier this year, then-Federal Reserve Chairman Greenspan noted that there is little legislative history explaining why Congress did not close the ILC loophole in 1987. He suggested that, "This may be because in 1987 ILCs generally were small, locally owned institutions that had only limited deposit-taking and lending powers under state law….Moreover, in 1987, the relevant states were not actively chartering new ILCs. Utah, for example, had a moratorium on the chartering of new ILCs at the time CEBA was enacted."[2]

Unfortunately, the ILC provision in CEBA has become a loophole that is as dangerous as the nonbank bank loophole that Congress closed in 1987 and the unitary thrift holding company loophole that Congress closed in 1999. Chairman Greenspan noted that, "The landscape related to ILCs has changed significantly since 1987….In 1997, for example, Utah lifted its moratorium on the chartering of new ILCs, allowed ILCs to call themselves 'banks,' and permitted ILCs to exercise virtually all of the powers of state-chartered commercial banks. In addition, Utah and certain other grandfathered states have since begun actively to charter new ILCs and promote ILCs as a method for companies to acquire a bank while avoiding the requirements of the BHC Act."[3]

As a result of this greatly increased activity, a charter that has existed for around 100 years in just a few states threatens to propel that charter and just those few states into dominance of the nation's financial system. As Chairman Greenspan pointed out, "while only a handful of states have the ability to charter exempt ILCs, there is <u>no</u> limit on the number of exempt ILCs these grandfathered states may charter in the future."[4] (emphasis in original)

The disparate nature of regulation and supervision of ILCs and their parent companies vis-a-vis other insured depository institutions and their parent companies is cause for concern. Current Federal Reserve Board Chairman Ben Bernanke told the House Financial Services Committee in February 2006 that Congress, not regulators, should take action on the ILC regulatory disparity. In March 2006 testimony before the Senate Banking, Housing and Urban Affairs Committee, Federal Reserve Governor Donald L. Kohn said that, "the Board continues to believe that Congress should *not* grant this new (de novo) branching authority to ILCs 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."

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[2] Attachment to Greenspan Letter, p. 2.
[3] Id.
[4] Id, p. 3.

It is increasingly clear that the narrowly intended ILC exception could eventually swallow the general rule, and a charter based in one state could irreversibly change our national financial landscape and our national financial policy without Congress having a say in the matter.

Here is the way Chairman Greenspan put it:

> These changes are undermining the prudential framework that Congress has carefully crafted and developed for the corporate owners of other full-service banks. Importantly, these changes also threaten to remove Congress' ability to determine the direction of our nation's financial system with regard to the mixing of banking and commerce and the appropriate framework of prudential supervision. These are crucial decisions that should not be made through the expansion and exploitation of a loophole that is available to only one type of institution chartered in a handful of states.[5]

Only the most myopic observer would not conclude that the ILC industry has changed dramatically in recent years, altering the relative risk profile of ILCs compared with other depository institutions. The rapid growth and changing nature of the ILC industry will be exacerbated if new commercial entities are permitted to gain access to the banking system through this loophole. The risk profile of an industry dominated by commercial ownership and the absence of consistent consolidated supervision is bound to be different than the risk profile of an industry that is subject to consolidated supervision and restricts commercial ownership.

For example, the sheer size of a commercial owner presents an increased risk to the Deposit Insurance Fund (DIF). The losses that the FDIC would endure if the bank or the parent company experienced financial problems could be extraordinary. To comment on one specific example, Tom Rubel, CEO of consultant Retail Forward Inc. predicted that "If [Wal-Mart] ever stumbles, we've got a potential national security problem on our hands. They touch almost everything....If they ever really went into a tailspin, the dislocation would be significant and traumatic."[6] A commercial company this large should not be permitted to place our banking system and the Deposit Insurance Fund at a similar risk.

Commercially owned ILCs face a number of risks that other depository institutions do not. For example, many are dependent on a reliable supply line, reasonable transportation and fuels costs, a dependable labor force, and are subject to fluctuations in the market for their particular products. A growing number of commercial retailers rely on foreign-made goods, which opens up another set of extraordinary risks. These firms may be subject to fluctuations in transportation costs and local currencies, not to mention the political stability of the nations with which they do business.

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[5] Greenspan Letter, p. 2.

[6] Business Week, *Is Wal-Mart Too Powerful?,* Oct. 6. 2003.

These risks are particularly significant because ILC parent companies are not subject to Federal Reserve oversight, leaving insufficient safeguards to protect the Deposit Insurance Fund.

We recognize that ILCs are subject to oversight by the FDIC, but as a General Accountability Office (GAO) study[7] has pointed out, the FDIC does not have the same powers to regulate the entirety of a holding company's operations as does the Federal Reserve. The BHCA provides the Federal Reserve with the authority to examine the bank holding company itself and any of its non-bank subsidiaries at any time, while the FDIC has only limited examination authority, and is unable to examine affiliates of banks unless necessary to disclose the direct relationship between the bank and affiliate and the effect of the relationship on the bank.

The Federal Reserve can also establish consolidated capital requirements to ensure that bank holding companies are a source of financial strength for the subsidiary bank. Corporate parents of ILCs are not subject to these capital requirements. Finally, the Federal Reserve has broad enforcement authority under the BHCA, can issue cease and desist orders, impose civil penalties, and order a holding company to divest non-bank subsidiaries if it determines that ownership of the subsidiary presents a risk to the financial safety, soundness, or stability of an affiliated bank and is inconsistent with sound banking principles or the purposes of the BHCA. The Federal Reserve is the only federal agency authorized to take such actions against bank holding companies.

The safeguards provided by Federal Reserve regulation are necessary to protect the Deposit Insurance Fund against the potential risks presented by a commercial owner of an ILC. Without these safeguards, it may be impossible for problems to be identified and managed in time to prevent deficiencies and damage to the federal safety net.

ICBA strongly supports legislation introduced by Reps. Paul Gillmor (R-OH) and Barney Frank (D-MA), the Industrial Bank Holding Company Act of 2006 (H.R. 5746), that would enhance the FDIC's supervisory authority over ILC holding companies and reduce risks to the deposit insurance fund. The Gillmor-Frank bill also severely limits the amount of commercial activity in which an ILC holding company may engage, thus greatly reducing the threats posed by commercial ownership.

ICBA also supports legislation introduced by Rep. James A. Leach (R-IA), the Financial Safety and Equity Act of 2005 (H.R. 3883), that would require any company that owns an ILC to conform to the Bank Holding Company Act by becoming a financial holding company. The bill would require companies to divest non-financial activities within five years. All ILC holding companies would undergo the same regulation and supervision by the Federal Reserve under the BHCA as amended by the Gramm-Leach-Bliley Act of 1999 that applies to financial holding companies that own banks that are not ILCs.

> *2. Do the risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund differ based upon whether the owner is a financial entity or a commercial*

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[7] "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-05-621, September 22, 2005 ("GAO Report").

> *entity? If so, how and why? Should the FDIC apply its supervisory or regulatory authority differently based upon whether the owner is a financial entity or a commercial entity? If so, how should the FDIC determine when an entity is "financial" and in what way should it apply its authority differently?*

There are greater risks to the economy and to the Deposit Insurance Fund when commerce and banking is mixed and commercial firms are allowed to own ILCs. Because of their size and dominance in the market, because they are more susceptible to fluctuations in the general economy, and because they are not subject to consolidated federal supervision, large commercial owners of ILCs pose more of a risk to the Deposit Insurance Fund than large financial holding companies. This is particularly true of the "big box" retailers like Wal-Mart or Home Depot that dominate their retail markets nationally and, in the case of Wal-Mart, internationally. As a Government Accountability Office (GAO) study concluded: "These ILC may pose more risk of loss to the bank insurance fund than other insured depository institutions operating in a holding company."[8]

Bank regulators—no matter how competent—do not have the expertise to understand the full array of risks posed by the business and operations of these retailers or other commercial entities in order to protect the safety and soundness of the ILC if the overall enterprise were to have financial problems.

For example, a recent applicant for an ILC charter was the Ford Motor Company. Ford's recent financial problems stemming from a slowdown in domestic car sales are so acute that Standard & Poor's Rating Service downgraded its corporate credit rating to BB-minus. Consequently, under banking regulations, Ford bonds would not even be eligible for purchase by banks. At this point, it is doubtful that Ford could be a source of strength for an FDIC-insured ILC since its financial problems could easily spread to all of its subsidiaries causing the failure of an ILC.

Like Ford, other ILC applicants are vulnerable to changes in their own markets. Wal-Mart, for instance, faces risks that other banks and commercial firms do not face. Since 70 percent of the products sold in Wal-Mart stores are produced in China, Wal-Mart faces financial risks due to currency fluctuations and the volatile transportation and fuels market. Wal-Mart has become China's eighth largest trading partner, and if Wal-Mart were a country, it would rank as China's eighth largest trading partner, ahead of Russia, Australia, and Canada. Notably, Wal-Mart's business model looks to expand its retail operation in China to surpass even its mammoth U.S. operations. Wal-Mart's systemic risk to the financial and payment system is likewise expanded globally to encompass the actions of other countries and political, currency and monetary systems.

Home Depot is the world's largest home improvement specialty retailer and the second largest retailer in the United States, operating more than 2,000 stores across North America and processing more than 1.33 billion customer transactions per year. While profitable today, with 2005 earnings of $5.8 billion, the specialized nature of Home Depot and its

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[8] "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority," GAO-06-961, July 12, 2006.

ILC acquisition target EnerBank, make them susceptible to fluctuations in the general economy, real estate sales, and specifically the home improvement market. Because Home Depot is susceptible to sudden changes in economic conditions, it may not always be a reliable source of strength for EnerBank. EnerBank is itself vulnerable, since its only business will be funding fixed-rate, unsecured, closed-end, direct consumer installment loans for a broad range of home improvement projects. Sudden changes in the home improvement market could send both Home Depot and EnerBank spiraling into a meltdown. EnerBank's lending portfolio will not be diversified enough to protect against such market volatility.

For these reasons, these commercial entities pose severe and unacceptable risks to the Deposit Insurance Fund.

One of the chief policy reasons for maintaining the separation of banking and commerce is to avoid having a federal banking regulator become involved in the market decisions of major commercial firm. If Enron and WorldCom had owned an ILC, their financial problems could easily have spilled over to their banks, draining the FDIC's resources and requiring all banks—including community banks—to cover the costs.

The potential for conflicts of interest increases dramatically when a commercial firm owns an ILC, adding to the risks to safety and soundness inherent in mixing commerce with banking. An ILC owned by a commercial company would have every incentive to (1) deny credit to an affiliate's competitor and steer credit to an affiliate's business partners, (2) provide preferential credit to its affiliate, and (3) tie the provision of credit to purchases of the affiliate's products. These conflicts are discussed in more detail in our answer to Question 8.

Commercial firms owning ILCs also pose more risks to the Deposit Insurance Fund because they are not subject to consolidated regulation and therefore to the same level of regulatory oversight as most financial firms, as more fully discussed below in our answer to Question 3.

ICBA strongly supports H.R. 5736, the Industrial Bank Holding Company Act of 2006 that would prohibit commercial firms from controlling industrial banks. The bill defines "commercial firm" as an entity (including its affiliates) that derives at least 15 percent of its annual consolidated gross revenues from activities that are not financial in nature or incidental to a financial activity during at least three of the prior four calendar quarters, as determined by regulations to be promulgated by the FDIC.

Conversely, the definition of a financial firm is one whose annual consolidated gross revenues are derived at least 85 percent from activities that are financial in nature or are incidental to a financial activity. Financial activities would include banking, brokerage or insurance activities.

As discussed below in response to Question 3, all companies that own an FDIC-insured ILC should be subject to consolidated supervision and regulation. If the Industrial Bank Holding Company Act of 2006 were enacted, all companies, both financial and otherwise, that own an ILC would have to register with the FDIC; file documents regarding their financial condition, ownership, operations, management, and subsidiaries; and be subject to examination and oversight by the FDIC. If the Financial Safety and Equity Act of 2005 were enacted, all companies owning ILCs would have five years to come into compliance with the conditions, requirements, restrictions and limitations applicable to financial holding companies under BHCA, including the activities and investment restrictions and consolidated supervision.

> *3. Do the risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund differ based on whether the owner is subject to some form of consolidated Federal supervision? If so, how and why? Should the FDIC assess differently the potential risks associated with ILCs owned by companies that (i) are subject to some form of consolidated Federal supervision, (ii) are financial in nature but not currently subject to some form of consolidated Federal supervision, or (iii) cannot qualify for some form of consolidated Federal supervision? How and why should the consideration of these factors be affected?*

The risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund are substantially reduced if the owner of the ILC is subject to some form of consolidated federal supervision. Holding companies that are subject to consolidated regulation under the BHCA, for instance, must comply with consolidated capital requirements and are subject to stricter supervision of the holding company and its nonbanking affiliates. Similarly, some financial companies are subject to regulation and oversight by the Securities and Exchange Commission or the Office of Thrift Supervision. Companies subject to supervision by federal financial regulators do not pose nearly the same risk as other firms, including commercial firms, that are not subject to consolidated regulation.

Consolidated Federal Supervision. The 2005 GAO Report on ILCs documents the advantages of consolidated federal supervision that bank holding companies are subject to under the BHCA, and conversely, the limitations of FDIC regulation over ILCs under the Federal Reserve Act.

For instance, under the BHCA, the Federal Reserve has the authority to examine the bank holding company itself and any of its non-bank subsidiaries at any time, while the FDIC has only limited examination authority, and is unable to examine affiliates of banks unless necessary to disclose the direct relationship between the bank affiliate and the effect of the relationship on the bank. According to the GAO:

> The FDIC's authority to examine an affiliate of an insured depository institution exists only to disclose the relationship between the depository institution and the affiliate and the effect of that relationship on the depository institution. Therefore, any reputation or other risk from an affiliate that has no relationship with the ILC could go undetected. In contrast, consolidated supervisors, subject to functional regulation restrictions, generally are able to examine a nonbank affiliate of a bank

> or thrift in a holding company regardless of whether the affiliate has a relationship with the bank.[9]

The GAO Report notes that as a result of their authority, consolidated supervisors such as the Federal Reserve or the Office of Thrift Supervision take a systemic approach to supervising depository institution holding companies and their nonbank subsidiaries. Consolidated supervisors, for instance may assess lines of business, such as risk management, internal control, IT, and internal audit, across the holding company structure in order to determine the risk these operations may pose to the insured institution. This allows the Federal Reserve or the OTS to determine whether holding companies that own or control insured depository institutions, as well as nonbank subsidiaries are operating in a safe and sound manner so that their financial condition does not threaten the viability of their affiliated depository institutions.

Consolidated Capital Requirements. Under the BHCA and more specifically, Federal Reserve Regulation Y, the Federal Reserve imposes consolidated capital requirements on bank holding companies to ensure that the holding company can serve as a source of financial strength for the subsidiary bank. Furthermore, the Federal Reserve can take enforcement action to protect the bank if the holding company ceases to serve as a source of financial strength to the bank. These important safeguards ensure that the holding company is adequately capitalized and protects against financial problems of the holding company threatening the solvency of the bank.

Enforcement Authority. Under the BHCA, the Federal Reserve can also issue cease and desist orders, impose civil penalties, and order a holding company to divest nonbank subsidiaries if it determines that ownership of the subsidiary presents a risk to the financial safety, soundness, or stability of an affiliated bank and is inconsistent with sound banking principles or the purposes of the Act.

These safeguards—consolidated regulation, consolidated capital requirements and greater supervision and enforcement authority—reduce the risks to the insurance fund of those holding companies that own an ILC. Without these safeguards, it may be impossible for financial problems to be identified early and managed in time to prevent deficiencies and damage to the federal safety net.

All companies that are not subject to consolidated federal supervision, whether they are financial or otherwise, pose significant risks to the Deposit Insurance Fund if they own an insured depository institution. As mentioned above, we believe that holding companies that are subject to the BHCA, pose significantly less risks to the Deposit Insurance Fund because of the safeguards provided under that Act. In our opinion, commercial firms should be prohibited from owning an ILC.

ICBA supports the Financial Safety and Equity Act of 2005, introduced by Rep. James A. Leach (R-IA) that would subject ILCs and their owners to the BHCA, thus limiting ILC

[9] GAO Report, p. 27.

ownership to financial companies and subjecting the ILC owners to Federal Reserve oversight and supervision as financial holding companies under the BHCA.

ICBA also endorses the Industrial Bank Holding Company Act of 2006 introduced by Reps. Paul Gillmor (R-OH) and Barney Frank (D-MA) that would require all companies, both financial and otherwise, that own an ILC to register with the FDIC and file documents regarding their financial condition, ownership, operations, management, and subsidiaries. The bill also would also authorize the FDIC to examine the holding company and its subsidiaries. Any nonbanking affiliate of the holding company would be subject to FDIC examination to determine the relationship of the affiliate to the holding company and the effect of the affiliate on the depository institution. The FDIC would also have enforcement powers similar to those of the Federal Reserve under the BHCA.

> *4. What features or aspects of a parent of an ILC (not already discussed in Questions 2 and 3) should affect the FDIC's evaluation of applications for deposit insurance or other notices or applications? What would be the basis for the FDIC to consider those features or aspects?*

While 12 U.S.C. 1816 gives the FDIC a broad range of issues to consider when evaluating an application for deposit insurance, ICBA believes that the implications of commercial ownership of ILCs are so grave that Congress should provide guidance. But, in the absence of such guidance, the FDIC should concentrate on the risks presented to the Deposit Insurance Fund as well as the convenience and needs of the community. (See our response to question 10 for a discussion of convenience and needs factors.) In particular, the FDIC should consider factors such as the size of the parent company, its market power, its behavior in the marketplace, its character and fitness, impact on competition, whether the parent is subject to consolidated supervision, and the nature of that supervision. Each of these factors can affect the safety and soundness of the ILC, the adequacy of the ILC's capital and, in turn, the risks to the Deposit Insurance Fund and the impact on the community.

> *5. The FDIC must consider certain statutory factors when evaluating an application for deposit insurance (see 12 U.S.C. 1816), and certain largely similar statutory factors when evaluating a change in control notice (see 12 U.S.C. 1817(j)(7)). Are these the only factors FDIC may consider in making such evaluations? Should the consideration of these factors be affected based on the nature of the ILC's proposed owner? Where an ILC is to be owned by a company that is not subject to some form of consolidated Federal supervision, how would the consideration of these factors be affected?*

Congress has provided the FDIC with a broad range of statutory factors to apply when considering applications for insurance and for changes of control. In the absence of further Congressional guidance, the FDIC should apply them with special care and thoroughness to ILC applications. Although those factors alone justify denying applications by commercial firms to acquire or form ILCs and to impose restrictions on ILCs and their parent companies, the best course would be for Congress to close the ILC loophole.

In addition to clearly blocking further commercial ownership of ILCs, Congress should broaden the statutory factors that the FDIC uses when considering an application for insurance under 12 U.S.C. 1816 and explicitly direct the FDIC to consider the effects of a holding company's activities and the implications of its control of the insured institution just as does the statute that governs changes of control (12 U.S.C. 1817(j)(7)).

The Wal-Mart application is a good illustration. At this point, Wal-Mart's "depository institution" contemplated in 12 U.S.C. 1816 does not exist in any meaningful form. It exists almost exclusively on paper, with a few employees designated to operate the institution if it is chartered and insured. And, even once it is operating, it will be closely controlled by the parent company. This is the likely state of affairs for any depository institution formed by a major firm, be it commercial or financial in nature. They are less like independent entities and more like operating offices of the parent companies.

The statute governing changes of control (12 U.S.C. 1817(j)(7)) is more expansively worded, speaking both of reducing competition generally and within the business of banking specifically. It also requires the FDIC to consider "the financial condition of any acquiring person," and "the competence, experience, or integrity of any acquiring person." The FDIC should consider all of these factors as well when a holding company is acquiring control of an FDIC-insured institution whether through a change in control or by chartering a new institution.

Even under the insurance application statute (12 U.S.C. 1816) the FDIC retains broad authority to protect the deposit insurance fund from losses and the public from harmful effects of ILC activities. As we have detailed in response to other questions, ILC ownership by commercial firms poses grave risks to the health of the financial system and the safety and soundness of the ILC itself. Therefore, even without a statutory change to explicitly broaden the factors the FDIC must consider for an application for insurance, ICBA believes that the FDIC could and should block commercial establishment or acquisition of an ILC and impose conditions on the relationships between other holding companies and ILCs.

This would be particularly important in cases where the parent of an ILC is not subject to consolidated supervision, or where consolidated supervision does not adequately address the holding company/ILC relationship. In those cases, the FDIC should consider denying the application or imposing conditions and engaging in additional supervision to protect against harm to competition and consumers, systemic risk, and to the deposit insurance fund.

> *6. Should the FDIC routinely place certain restrictions or requirements on all or certain categories of ILCs that would not necessarily be imposed on other institutions (for example, on the institution's growth, ability to establish branches and other offices, ability to implement changes in the business plan, or capital maintenance obligations)? If so, which restrictions or requirements should be imposed and why? Should the FDIC routinely place different restrictions or requirements on ILCs based on whether they are owned by commercial companies or companies not subject to some form of consolidated Federal supervision? If*

such conditions are believed appropriate, should the FDIC seek to establish the underlying requirements and restrictions through a regulation rather than relying upon conditions imposed in the order approving deposit insurance?

Imposing restrictions or requirements on some or all categories of ILCs is not the answer to protect against the safety and soundness risks or the negative effects inherent in the ownership of ILCs by certain types of entities, particularly ILC owners that are commercial companies, or not otherwise subject to consolidated supervision and regulation.

That said, ICBA recognizes that as the nature or character of an ILC's business grows and changes, the negative effects on competition, convenience and needs of the community, conflicts of interest, safety and soundness, etc. will be magnified. For these reasons, restrictions on growth, branching ability, changes in the institution's business plan or capital maintenance obligations may be attractive to the FDIC.

If the FDIC were to consider restrictions or conditional approval, the FDIC should weigh whether the parent company is a financial company or a commercial company. Financial companies are permitted to own banks under the BHCA as amended by the Gramm-Leach-Bliley Act. Thus, Congress has determined that ownership of an FDIC-insured institution that is able to conduct a full array of banking activities is appropriate for financial companies, albeit subject to consolidated supervision that is lacking in the case of ILCs

Unlike in Gramm-Leach-Bliley, the Congress has not determined that ownership of an FDIC-insured institution able to conduct a full array of banking activities through an FDIC-insured subsidiary is appropriate for commercial companies. The provision in the BHCA that creates the ILC loophole and therefore commercial ownership does not contemplate unlimited banking powers for ILCs. It provides that ILCs (other than grandfathered ILCs) are to remain small (under $100 million), limit their product or service offerings (no demand deposits), or not engage in any activities they were not lawfully engaged in as of March 5, 1987.

Former Senator Jake Garn reaffirmed the intended limited nature of ILCs in testimony before the FDIC at its public hearing on April 10, 2006, on Wal-Mart's application for deposit insurance for its proposed Utah-chartered ILC. Senator Garn stated that ILCs were not intended to engage in retail operations:

> This bill [Competitive Equality Banking Act of 1987] was very specific in what [ILCs] could do. And I've already stated that if somebody tried to modify with you or Utah or any other state that has industrial banks and allowed them in retail operations, I would be the most vociferous opponent of that because that was not my intent at the time that CEBA was passed….
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> The [ILCs] that are operating in Utah, they don't have teller windows in their stores, they're not out soliciting…. That's why I repeat, I would be the first one here, whether it's Wal-Mart or any of the existing ones came back to expand that into retail banking, I would be the first one there opposing it.

Wal-Mart's application provides a perfect example of why conditional approval is inadequate. Wal-Mart has cleverly submitted an application that includes a limited business plan initially limited to providing electronic transaction processing for Wal-Mart stores, plus above-market-rate deposits for charities and other non-profits. However, there is little to prevent Wal-Mart from obtaining its charter then expanding its payments operations to include processing payments for its tens of thousands of suppliers in the United States, and/or expanding its banking operations to include full retail banking, with a wide array of deposit and loan services, at its stores across the country. Wal-Mart's desires to expand its financial services offerings are of public record. It has taken numerous steps in that regard.

The potential for anticompetitive behavior, conflicts of interest and negative effects on the convenience and needs of the community, and safety and soundness will grow as Wal-Mart's ILC expands its activities and operations. For example, Wal-Mart could require that all of its suppliers use the Wal-Mart ILC for payments services as a condition of doing business with Wal-Mart. Wal-Mart's undue influence given it dominant role in the global economy would increase concentration in the payments system and increase risks to the objectivity and security of the payments system

If Wal-Mart ILC expands into branch banking, the impact on local communities could be devastating as Wal-Mart siphons deposits from local institutions or becomes a key source of credit. The Wal-Mart ILC would have no incentive, in fact it would have disincentive, to lend to small businesses or retailers that compete with Wal-Mart.

Even if the FDIC approves Wal-Mart's application with conditions or restrictions, there is nothing to prevent a future FDIC board from lifting or modifying those restrictions and allowing Wal-Mart to change its business plan and expand its operations once its ILC application is approved.

If the FDIC did conclude that such conditions are appropriate, the FDIC should seek to establish underlying requirements and restrictions through a regulation rather than relying on conditions imposed in the order approving deposit insurance. Conditions imposed in an order are too easily lifted or modified and afford the public and other interested stakeholders no opportunity inform the debate and discussion as would be provided by a notice and comment rulemaking.

> *7. Can there be conditions or regulations imposed on deposit insurance applications or changes of control of ILCs that are adequate to protect an ILC from any risks to safety and soundness or to the Deposit Insurance Fund that exist if an ILC is owned by a financial company or a commercial company? In the interest of safety and soundness, should the FDIC consider limiting ownership of ILCs to financial companies?*

ICBA is gravely concerned that there are no conditions or regulations that are adequate to protect an ILC from any risks to safety and soundness or to the deposit insurance fund that exist if the ILC is owned by a commercial company.

As noted above in Question 6, conditions imposed with an approval order are subject to being lifted or modified with relative ease by a future FDIC board. Thus, it is inadequate to seek to protect an ILC from the significant safety and soundness risks inherent in commercial company ownership by imposing conditions on approval.

As for financial companies, ICBA is concerned that the FDIC may not have the authority to impose conditions or regulations that would result in the same degree of protection that is afforded, for example, through the consolidated supervision and oversight of parent companies of banks through the BHCA. As the GAO Report noted, the FDIC's supervisory authority over the holding companies and affiliates of ILCs is more limited than the authority that consolidated supervisors have over the holding companies and affiliates of banks and thrifts. For example, the FDIC's authority to examine affiliates and take certain enforcement actions against them is more limited than consolidated supervisor.

We question whether it is possible for the FDIC to assert the same degree of consolidated oversight through conditions imposed when approving ILC applications or through regulations in the absence of a statutory scheme for oversight and regulation of ILC parent companies.

> *8. Is there a greater likelihood that conflicts of interest or tying between an ILC, its parent, and affiliates will occur if the ILC parent is a commercial company or a company not subject to some form of consolidated Federal supervision? If so, please describe those conflicts of interest or tying and indicate whether or to what extent such conflicts of interest or tying are controllable under current laws and regulations. What regulatory or supervisory steps can reduce or eliminate such risks? Does the FDIC have authority to address such risks in acting on applications and notices? What additional regulatory or supervisory authority would help reduce or eliminate such risks?*

The potential for conflicts of interest and safety and soundness risks increase dramatically when banking and commerce is mixed and a commercial firm that is not subject to consolidated regulation owns an FDIC-insured ILC. The ILC would have every incentive to (1) deny credit to an affiliate's competitor and steer credit to its business partners, (2) provide preferential credit to its affiliate, and (3) tie the provision of credit to purchases of the affiliate's products.

Denying Credit to the Affiliate's Competitors. The potential for denying credit to an affiliate's competitor would be particularly strong among the "big box" retailers. If Wal-Mart, for instance, owned an ILC, we doubt that a competing local hardware or clothing store, a local pharmacy, grocer or someone wishing to establish a new store would be able to obtain credit from the Wal-Mart bank, or want to share its confidential business plans with the bank when applying for a loan. The Wal-Mart bank would have no incentive—in fact it would have a disincentive—to lend to businesses that compete with its parent company. Instead of making impartial credit decisions based on the creditworthiness of the borrower as banks are meant to do as neutral arbiters of credit, the Wal-Mart bank would have incentive to deny credit, not on the merits, but because of a conflict of interest and its relationship with Wal-Mart. At minimum, Wal-Mart Bank could impose injurious credit terms and conditions that could impact the competitiveness of the new entity.

Ownership by Wal-Mart would have a similar effect on the bank's decision-making with regard to credit applications by Wal-Mart suppliers. Again, instead of making credit decisions on the merits of a borrower's creditworthiness, the Wal-Mart bank would have an incentive to favor Wal-Mart's suppliers and disfavor their competitors. In fact, Wal-Mart could require its suppliers to obtain their banking and credit services from the Wal-Mart bank if they want to do business with Wal-Mart, using its market power to lessen competition.

Preferential Loans and Section 23A. In the case of a commercial firm owning an ILC, there will also be an incentive for the ILC to lend preferentially to its commercial affiliate. This could be particularly strong if, for instance, the bank has better access to lower cost funds than the affiliate. Although Sections 23A and 23B of the Federal Reserve Act addresses this issue by restricting the amount and terms under which banks can lend to their affiliates, commercial firms and their ILCs will always be under stronger pressure than financial firms to find a way to bypass those restrictions.

For instance, if Home Depot is allowed to complete its acquisition of EnerBank, it will have every incentive to pressure EnerBank to make home improvement loans to Home Depot customers so that those customers will purchase goods and services from Home Depot. Under Section 23A, if the loan proceeds will benefit the affiliate, those loans should be considered "covered transactions" and subject to the quantitative limits of the law. However, we fear that EnerBank may structure such transactions as loans to purchase goods or services from an independent contractor, not Home Depot, even though the contractor may be on Home Depot's list of "approved contractors" and may even be affiliated with Home Depot. Since there are always ways to bypass or bend a law or regulation, ICBA fears that commercial firms will have a particularly strong incentive to bypass Section 23A to avoid the quantitative limits of that law.

Tie-in Arrangements. Similarly, the potential for tie-in arrangements increases significantly when commercial firms own ILCs. The pressure to tie the ILC's loan products, for instance, with products from an affiliate would be significant. Ford Motor Company, might, for instance, want to tie a discount on a car to obtaining a loan from Ford's ILC. Similarly, if Home Depot acquires EnerBank, it might tie a lower price of a product or service to obtaining a loan from EnerBank. Even if the tie-in is not explicit, customer could easily feel pressure from contractors to borrow from EnerBank, and contractors and borrowers would feel pressure to buy goods at Home Depot.

Although the anti-tying rules under the BHCA[10] would prohibit the bank from tying its products and services to those of an affiliate, the affiliate would not be prohibited from tying its products and services to those of the bank and commercial firms would have a strong incentive to bend the rules or exploit an exception. For example, commercial firms may argue that the tying arrangements are really cross-selling and are therefore legal.

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[10] See 12 U.S.C. Sections 1971-78 (2001)

Furthermore, tying is permitted under the Act when the transaction is requested by the customer rather than initiated by the bank so there may be attempts by commercial firms to structure their tie-in arrangements as initiated by the customer.

Inside Information. Another potential conflict of interest is the use of inside information to benefit the ILC at the expense of the affiliate. For instance, a commercial affiliate may want access to confidential information concerning the financial status of the ILC's commercial customer before purchasing services or equipment from that customer. Conflicts could also arise if the commercial affiliate pressures the ILC to make a loan to a customer that owes money to the commercial affiliate. Although these types of conflicts would also arise if the ILC affiliate was a financial entity, we believe the potential for conflict is greater when the affiliate is a commercial firm.

> *9. Do ILCs owned by commercial entities have a competitive advantage over other insured depository institutions? If so, what factors account for that advantage? To what extent can or should the FDIC consider this competitive environment in acting on applications and notices? Can those elements be addressed through supervisory processes or regulatory authority? If so, how?*

All ILCs, regardless of ownership, have a competitive advantage over other depository institutions arising from their exemption from the BHCA and its ownership restrictions and regulatory requirements. Conversely, institutions operating in states that do not charter ILCs operate at a tremendous disadvantage because they are restricted in their ownership and are subject to consolidated supervision by the Federal Reserve. Thus, ILCs as an institution represent a parallel but superior banking system that disadvantages institutions in other states. This is unfair to institutions in non-ILC states.

In addition to these inherent advantages, ILCs owned by commercial firms have even greater advantages:

- They may benefit from operating efficiencies because of commercial affiliations;
- They may benefit from a built-in delivery system that may include geographic advantages;
- They may benefit from the trademark and good will engendered by the commercial owner;
- They may benefit from marketing campaigns designed for the commercial owner, including cross-marketing opportunities; and
- They may benefit from access to capital not available to institutions not owned by commercial firms.

As discussed more fully in our answer to Question 10, these benefits would result in a competitive imbalance in the banking industry that would reduce competition and create oligopolies to the detriment of the consumer. Examples are the applications by Wal-Mart to charter an ILC and by Home Depot to acquire an ILC.

And if either Wal-Mart or Home Depot decided to change its business plan for its ILC down the road, with thousands of locations in North America, each would have a ready made brick and mortar network in place to create one of the largest branch banking operations in the nation.

These advantages are not available to institutions now owned by commercial firms.

Some would argue that these potential advantages accrue benefits to consumers. That may well be true in the short run. For instance, consumers may well benefit from cut-rate interest on home improvement loans while Home Depot is building its customer base in a particular market. However, when the competition disappears, consumers will be at the mercy of Home Depot which could raise interest rates and fees at will.

Allowing banks to be owned by commercial firms would send the U.S. down an irreversible and destructive path that led to a 15-year recession in Japan and countless difficulties in other nations. The only way to truly protect the U.S. financial system, which is the envy of the world, is to maintain the separation of banking and commerce:

- Separating banking and commercial interests guards against excessive concentration of economic power.
- It ensures the impartial allocation of credit, protecting the economy against conflicts of interest, and from credit being approved for competitive reasons, not because of the creditworthiness of the borrower.
- It safeguards against improper extension of the federal safety net, which would put taxpayer dollars at risk.
- Mixing banking and commerce has been a failed experiment across the globe. Kieretzu arrangements in Japan have contributed to a 15 year recession.

The FDIC should take these factors into account when considering whether to approve applications for ILCs from commercial owners.

The fundamental dangers and weaknesses of allowing ILCs to be owned by commercial firms cannot be addressed through the regulatory process. The only way to safeguard our financial and economy viability is to close the ILC loophole and prohibit future commercial ownership of ILCs.

10. Are there potential public benefits when a bank is affiliated with a commercial concern? Could those benefits include, for example, providing greater access to banking services for consumers? To what extent can or should the FDIC consider those benefits if they exist?

Any possible public benefits from having a bank affiliated with a commercial concern would be fleeting at best and outweighed by the severe risks the affiliation would cause. Any benefits could be supplied through other means that do not pose the risks involved in mixing banking and commerce. Two major commercial applicants for ILC charters, Wal-Mart and Home Depot, illustrate these points.

Wal-Mart. Wal-Mart's stated plan is to use its ILC to process payments its customers make in its stores. It has never asserted that its current payment processing arrangements are inadequate or that they do not provide high quality service to its customers. Wal-Mart simply wishes to reduce its expenses in this area. While this is a normal corporate motive, it neither improves consumer access to banking services nor outweighs the tremendous conflicts of interest the plan entails.

Just as significantly, Wal-Mart could easily change its business plans and move into retail banking. Given the broad ability to collect deposits, whether through a branch network or through the Internet or other non-branch marketing strategy, there is the genuine danger that Wal-Mart Bank will export deposits out of the local community. This has been the current pattern of the large retailer when it establishes itself in a local community. Wal-Mart's current deposits do not stay with local banks, but rather are wired overnight to the store's central headquarters and even used for its vast global expansion plans. In the past, this pattern has had a devastating effect on local communities as retail dollars spent in the community are exported elsewhere and do not remain in the community to support local lending and economic development.

The industrial bank charter would allow Wal-Mart to gain deposits by offering certificates of deposit (CDs) and NOW accounts. Additionally, legislative attempts are underway in the U.S. Congress to expand the industrial bank charter's bank powers so they can offer interest-bearing NOW accounts to businesses, in essence giving them full banking powers. Unlike local banks that use their deposits for local lending, deposits collected by an international commercial operation like Wal-Mart could be easily exported outside the local community in which they are collected. Would other banks survive to offer alternative sources of local credit?

A study conducted by the Federal Reserve Bank of Kansas City[11] found that community bank funding challenges present a persistent, long-term problem that if not addressed, will "eventually force them to curtail lending to small businesses, farmers, and other local customers – many of whom may have few other places to turn to for their borrowing needs." Wal-Mart's potential exportation of deposits and capital out of a community will exacerbate local small business funding challenges.

Wal-Mart is frequently criticized for de-stabilizing communities and having a destructive impact on local businesses. Its predatory pricing policies have driven thousands of local companies out of business, to the detriment of those communities. Wal-Mart could do the same to community banks, depriving affected communities of a strong stakeholder resource. Wal-Mart Bank would divert capital out of the community, and could skew loan decisions by steering capital away from businesses that compete with it.

As discussed above in Questions 8 and 9, separating banking and commercial interests ensures the impartial allocation of credit, protecting the economy against conflicts of interest, and from credit being approved for competitive reasons, not because of the creditworthiness of the borrower.

[11] "The Decline in Core Deposits: What Can Banks Do?" by James Harvey and Kenneth Spong, The Federal Reserve Bank of Kansas City, published in Financial Industry Perspectives 2001.

Fortunately, there are viable alternatives to allowing Wal-Mart to enter the payments system and having branches of the Wal-Mart ILC located in Wal-Mart stores. Wal-Mart's current payments arrangements appear to be working well. Many community banks have opened branches in Wal-Marts and other stores throughout the country. Consumers receive the convenience of doing their banking while doing their other shopping, while the financial system avoids the risks posed by mixing banking and commerce.

Home Depot. There is no evidence that the credit needs of home improvement loan customers are not being met by conventional sources, such as banks, thrifts and credit unions. Indeed, community financial institutions are constantly looking for new opportunities to serve their customers, build their communities, and strengthen their loan portfolios, and most have ample funds available to do so.

Neither is there any evidence that Home Depot needs an additional credit outlet for its home improvement customers. Indeed, Home Depot states in its notice that it "already finance[s] home improvements with credit cards and home improvement loans marketed directly to consumers."[12] With Home Depot's profits growing at a rate of 17 percent annually, these methods are obviously working, raising questions about the need for an additional source of credit for Home Depot's customers. It is unclear in the application whether these direct marketing efforts will cease or continue if Home Depot acquires EnerBank.

A Home Depot-owned bank, like a Wal-Mart bank, would create competitive imbalances in the banking industry and inflict lasting damages on community banks and thereby the communities they serve.

A Home Depot-owned bank would have the size and resources to engage in predatory pricing to capture the local home improvement loan market to the detriment of locally-owned banks. With Home Depot's resources backing EnerBank, it would have the ability to unfairly undercut loan rates offered by local banks, resulting in lost business opportunities and lower earned interest for community banks.

The marketing technique that Home Depot intends to employ with EnerBank could reduce competition and ultimately result in higher costs for consumers. And even though the notice states loans will not be specifically tied to a Home Depot purchase, since the contractor would be introduced to the bank through Home Depot, this no doubt would build a loyalty to Home Depot products, exactly what Home Depot's stated purpose is.

In addition, EnerBank would actually train contractors to close deals, presenting concerns regarding adequate provision of consumer disclosures such as Truth in Lending disclosures, etc. These contractors are neither employees of Home Depot nor the bank, raising concerns about who will ensure consumers receive proper disclosures and other legally required information.

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[12] Home Depot Change in Control Notice, page 11.

Therefore, we believe that any conceivable consumer benefits from a Home Depot ILC charter are overbalanced by the clearly foreseeable consumer harms.

FDIC's Authority / Congressional Action. The FDIC must consider the "convenience and needs of the community to be served by" an applicant for insurance.[13] Certainly, this provides the FDIC statutory authority to consider the question of whether the disadvantages of mixing of banking and commerce would outweigh any conceivable benefits to consumers.

Given these facts, the FDIC should carefully consider whether the convenience and needs of the community are served when credit decisions are skewed because of competitive considerations and local deposits are exported outside the community, creating a funding and investment vacuum that hurts consumers, small businesses, and municipalities alike.

Indeed, these considerations are so compelling, we believe that Congress will find that they justify closing the ILC loophole by clearly preventing any commercial firm from acquiring or establishing an ILC. But, even if Congress cannot act quickly, the FDIC has the legal authority to exercise its independent judgment and block commercial ownership of ILCs.

> *11. In addition to the information requested by the above questions, are there other issues or facts that the FDIC should consider that might assist the FDIC in determining whether statutory, regulatory, or policy changes should be made in the FDIC's oversight of ILCs?*

ICBA urges the FDIC to consider the original purpose of ILCs in the context of the banking and commerce debate that Congress has revisited from time to time—with Congress always determining that banking and commerce should remain separate. An obscure exception or loophole in the law should not become a vehicle through which the financial and economic landscape of our nation is rearranged, or to create a parallel banking system with different rules and regulations than those that govern the "regular" banking system. For this reason, ICBA strongly urges the FDIC to maintain the moratorium on ILC formations or acquisitions until Congress has an opportunity to act. The policy determinations at stake in the ILC debate are within the purview of Congress.

> *12. Given that Congress has expressly excepted owners of ILCs from consolidated bank holding company regulation under the Bank Holding Company Act, what are the limits on the FDIC's authority to impose such regulation absent further Congressional action?*

Final resolution of the issues that have been raised in the ILC debate will require Congressional action. ICBA urges the FDIC: to extend the moratorium to give Congress the opportunity to act; to hold public hearings on the ILC issue to further inform the debate and allow for consideration of the views of the public; and to support legislation that will prohibit commercial ownership of ILCs and provide for comprehensive, consolidated regulation of ILCs and their parent companies.

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[13] 12 U.S.C. 1816(6).

Thank you for the opportunity to comment.

Sincerely,

Karen M. Thomas

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