

Please accept the attached two items as comments on the Final Interagency Q&A on CRA: (1) My previous Sept. 10, 2007 comment and (2) My Dec. 19, 2008 American Banker article addressing these same issues. Thank you,

Kenneth H. Thomas, Ph.D.

**Testimony of Arthur C. Johnson
on Behalf of the American Bankers Association
before the
Federal Deposit Insurance Corporation
on the Deposit Insurance Application of Wal-Mart Stores, Inc.
Washington, DC
April 10, 2006**

Mr. Chairman, I am Arthur C. Johnson, Chairman and Chief Executive Officer of the United Bank of Michigan, headquartered in Grand Rapids, Michigan. United Bank of Michigan is a community bank with \$425 million in assets, with five suburban branches in the Grand Rapids area and five branches in neighboring rural communities.

I also serve as Chairman of the Government Relations Council of the American Bankers Association (“ABA”), and I am testifying today on behalf of the ABA. The ABA brings together all categories of banking 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.

The ABA opposes the application to the Federal Deposit Insurance Corporation (“FDIC”) by Wal-Mart Stores, Inc. (“Wal-Mart”) for federal deposit insurance for a proposed Utah industrial bank, Wal-Mart Bank. This application brings into focus the concerns of our membership about the extent to which the current regulatory structure for industrial banks and industrial loan corporations (“ILCs”) can result in a broad erosion of

the separation between banking and non-financial commerce that has served our banking industry and our nation so well.

Congress has on numerous occasions reinforced the basic principle of separating banking from non-financial commerce. That issue, from a congressional and public policy viewpoint, should be considered settled.

Background

A brief discussion of the history of ILCs helps place into context the issues raised by the application.

History of ILCs. Industrial loan corporations had their genesis in banks chartered by states in the early 1900s to provide uncollateralized consumer loans to low- and moderate-income workers unable to obtain such loans from existing commercial banks.¹ Although at first, the FDIC held that ILCs were not eligible for federal deposit insurance, its policy changed over time until, with passage of the Garn-St Germain Depository Institutions Act of 1982, all ILCs were granted eligibility for deposit insurance, as were the thrift certificates they offered in lieu of deposits.² Some states thereafter *required* ILCs to obtain FDIC insurance as a condition of chartering, with the result that by 1987, the FDIC insured most ILCs and shared supervision with their state charterers.

¹ GAO-05-621 *Industrial Loan Companies*, September 15, 2005.

² Pub. L. No. 97-320 § 703.

In 1987, Congress enacted the Competitive Equality Banking Act (“CEBA”), one of the primary purposes of which was to close the so-called “non-bank bank loophole.” Because the definition of “bank” in the Bank Holding Company Act at that time included only entities that offered commercial loans *and* accepted demand deposits, a number of large retail commercial entities had chartered institutions that made loans but did not offer demand deposits, thereby avoiding supervision as bank holding companies and enabling them to offer banking services on an interstate basis.

When Congress amended the definition of “bank” in the Bank Holding Company Act to eliminate the non-bank bank loophole, it also provided an exemption from that definition for certain ILCs that:

- 1) do not accept demand deposits that can be withdrawn by check or similar means for payment to third parties;
- 2) have total assets of less than \$100 million; *or*
- 3) have not undergone a change in control after 1987.³

The exemption applied to a comparatively few, small institutions. In 1987, most ILCs had less than \$50 million in assets. The few states that were able to charter ILCs were not promoting the charter. In fact, at the time, Utah had a moratorium on the creation of new ILCs. In short, there was no significant risk that the problems caused by mixing banking and non-financial commerce would seriously arise from the ILCs that existed at the time that the exemption was codified.

³ The exemption applies only to ILCs chartered in states that in 1987 required ILCs to have deposit insurance, namely, California, Colorado, Hawaii, Minnesota, Nevada and Utah.

Almost twenty years later, the characteristics of ILCs have changed dramatically. Since 1987, aggregate growth in ILC assets has increased over 3,500 percent, from \$3.8 billion to over \$140 billion in 2004, with the average ILC holding \$2.5 billion in assets. The number of ILCs also has significantly increased as certain states have begun actively to promote this charter as a means to own a bank without being regulated as a bank holding company. According to the GAO report, although seven states have active ILCs, California, Nevada and Utah charter more than half, with the state of Utah leading in ILC asset growth.⁴ This is not an accident. In 1997, Utah lifted its moratorium on new charters, permitted ILCs to call themselves “banks,” and authorized them to engage in virtually all of the powers of state-chartered banks.

Today, an ILC—even one with *more* than \$100 million in assets—may effectively compete with full-service insured depository institutions. As recently observed by 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.”⁵

⁴ The GAO report states that “As of December 31, 2004, there were 29 ILCs, representing 82 percent of the ILC industry assets, with headquarters in Utah. According to officials at the Utah Department of Financial Institutions, ILC growth in Utah occurred because other state laws are not as ‘business friendly’ as Utah. These officials also stated that Utah has state usury laws that are more desirable than many other states and the state offers a large well-educated workforce for the financial institutions industry.” GAO-05-621, *Industrial Loan Companies*, September 15, 2005 at 19.

⁵ Letter from Federal Reserve Board Chairman Alan Greenspan to Congressman James Leach dated January 20, 2006.

Historical Separation of Banking and Non-Financial Commerce. Our banking laws historically have provided for the separation of banking and non-financial commerce to protect depository institutions, the federal deposit insurance fund, and our financial system in general from a variety of potential risks. The rationale is clear—the banking industry is carefully regulated for safety and soundness and systemic risk because of the critical nature of the industry to the functioning of our economy. By contrast, non-financial firms are regulated under differing programs and for a variety of purposes.

Permitting the ownership of a bank by a non-financial commercial firm creates a number of risks, not the least of which is managing a large company where the importance of banks requires a priority draw on the talent and resources of the firm, a priority that in competition with the basic non-financial interests and history of the firm might not be readily forthcoming. Will the best talent of a manufacturing company be devoted to the bank and will the bank have top draw on such a company's financial resources? The importance of banking to the financial system requires nothing less, but shareholders and management may have other priorities. Such conflict of priorities is unlikely to arise when the entire business of the firm is financial in nature. The business mortuary of America is filled with failed companies that became so diverse that they did not know what they did. We cannot tolerate such a failure in banking.

Over the past 50 years, Congress has repeatedly acted to close avenues through which non-financial commercial entities could own depository institutions. The Bank

Holding Company Act of 1956 prohibited companies that owned two or more banks from engaging in non-financial commercial activities. In 1970, Congress extended that prohibition to companies that owned only a single bank. In 1987, Congress closed the so-called “non-bank bank” loophole. Most recently, the Gramm-Leach-Bliley Act closed the door on non-financial commercial entities owning a single savings association.⁶

The ABA has consistently supported these efforts. As recently as September 25, 2005, our Board of Directors unanimously reaffirmed ABA’s position that non-financial commercial firms should not be engaged in acquiring and chartering banks, including ILCs.

Current bills in Congress continue to reflect a heightened interest in preserving the separation between non-financial commerce and banking, with the current focus directed to the risks posed by ownership of ILCs. In 2005, Representatives Barney Frank and Paul Gillmor crafted legislative language that would prohibit industrial loan companies that are controlled by “commercial firms”—defined as any company that obtains on a consolidated basis more than 15 percent of its gross revenues from activities that are non-financial in nature—from exercising certain new powers to be granted by Congress. The “Business Checking Freedom Act of 2005” would prohibit commercially controlled industrial loan companies from offering interest bearing business checking accounts,⁷ while the “Financial Services Regulatory Relief Act of 2005”⁸ would prohibit interstate branching by commercially controlled industrial loan companies.

⁶ Pub. L. No. 106-102 (1999).

⁷ H.R. 1224, which was overwhelmingly passed by the House on May 24, 2005.

ABA supports these recent initiatives, just as it has long supported Congressional efforts to prevent non-financial commercial companies from owning depository institutions.

Issues Raised by the Wal-Mart Application

The public portion of Wal-Mart Bank's deposit insurance application indicates that the bank's activities are to be limited to processing its own transactions in the Visa and MasterCard networks. The bank will also provide certificates of deposit to two classes of depositors: non-profit, charitable and educational 501(c)(3) organizations; and individual investors serviced through deposit brokers. However, because the business plan portion of the application is not available publicly, it is impossible to comment with any assurance on Wal-Mart's assertions concerning the limited nature or duration of its activities. Even from what is known, the risks of bank ownership by a non-financial firm are present, and these risks would only be increased by any other current or future plans for additional banking activities.

There is reason to believe that these plans could be expansive. Wal-Mart has attempted on several occasions to enter the full-service banking business. In 2002, Wal-Mart attempted to acquire a California ILC; however, the state amended its law governing ILCs to prevent commercial entities from owning ILCs. In 1999, Wal-Mart attempted to acquire an Oklahoma savings and loan, but was blocked when Congress

⁸ H.R. 3505, which was overwhelmingly passed by the House on March 8, 2006.

closed the unitary thrift holding company loophole with passage of the Gramm-Leach-Bliley Act.

Already, according to reports in the *American Banker*,⁹ Wal-Mart has begun testing full-service Wal-Mart money centers for using stored-value cards, debit cards, and automated teller machines. This is being done under the direction of the same leadership of Wal-Mart Financial Services that is also slated to lead the board of directors of the new Wal-Mart Bank.

Although Wal-Mart has partnered with commercial banks to operate in-store branches, it is rolling out Money Center Express (“MCX”) machines that will permit customers to use credit or debit cards to withdraw cash, purchase or load cash onto Wal-Mart shopping cards and phone cards, make payments on Wal-Mart store credit cards as well as Wal-Mart and Sam’s Club-branded Discover cards, and purchase money orders.¹⁰ MCX is owned by Wal-Mart. The store is also test-marketing in Phoenix, Baton Rouge and northern Arkansas a Wal-Mart debit card that could be loaded with cash or payroll checks and used at merchants that accept PIN-based debit cards on the Cirrus, Star or Maestro networks.

Thus, Wal-Mart has both a demonstrated appetite to engage in full-service banking and a recent and ongoing track record of expanding the retail banking services it can offer under current law. It is disconcerting to realize that once a Wal-Mart bank

⁹ “Wal-Mart’s Financial Vision In Retail: Focus on Unbanked, Partnerships, Home Grown ATMs,” *American Banker*, October 5, 2005.

¹⁰ *Id.*

obtains deposit insurance, there would seem to be little or no opportunity for the public to comment on the bank's expansion into other products, services, or geographies.

In short, Wal-Mart's application presents an unprecedented challenge to what has been the settled policy of this government of keeping banking and non-financial commerce separate. The current retail banking products and services offered by Wal-Mart Financial Services raise serious doubts about whether Wal-Mart Bank would remain satisfied to engage only in payment processing and limited deposit-taking.

Conclusion

The Wal-Mart application presents the potential for a direct and irreparable breach of the wall separating banking from non-financial commerce. The combination of (a) the world's largest retailer, (b) an expressed desire to offer full-service banking, and (c) the opportunity to obtain a flexible bank charter present an unprecedented challenge that cannot be overlooked if this longstanding national policy is to be preserved. The ABA believes that banking is too important to the nation to try such a risky experiment. Accordingly, we oppose the application.



Viewpoint: CRA Due Diligence More Critical than Ever

American Banker | Friday, December 19, 2008

By Kenneth H. Thomas

One of the main lessons learned from the current crisis is that not all investments, whether collateralized debt or mortgage obligations, are what they appear, despite claims and even ratings by a third party.

A related lesson, especially in light of the recent Madoff scandal that has impacted several large financial institutions, is that banks must exercise their own due diligence not only in selecting their investments but also with the third parties with whom they deal.

Recent regulatory releases have addressed these issues relative to Community Reinvestment Act investments. They have taken on new importance with the proposed expansion of CRA to nonbank financial institutions and others receiving government bailout funds.

Assuming this initiative moves forward under the increasingly pro-consumer climate in Washington, including the pro-CRA efforts of House Financial Services Committee Chairman Barney Frank, these newly covered companies would mainly meet their proposed CRA obligations via qualified investments.

The latest interagency Q&A on CRA (<http://edocket.access.gpo.gov/2007/pdf/07-3223.pdf>) reaffirms credit for indirect investments through a fund whose primary purpose is community development. Community development and related funds can represent excellent opportunities to comply with CRA's Investment Test and Community Development Test.

The recent regulatory discussion of meeting CRA's geographic requirements by investing in a national or regional fund raised for the first time the issue of "double counting" of the same investment for more than one investor. Community groups have been raising the double-counting issue for some time.

The regulators specifically state that "... a financial institution has not demonstrated that the investment meets the geographic requirements of the CRA regulation if the fund 'double-counts' investments, by earmarking the same dollars or the same portions of projects or investments in a particular geography to more than one investor."

It is important to note that none of the large number of national or regional funds that exist were named by the regulators, nor are any specific funds being directly or indirectly referenced here.

This regulatory statement adds a new dimension to banks' due diligence in CRA investing. Self-serving claims by funds or their managers that they have never practiced double-counting is not enough in the current Sarbanes-Oxley and financial crisis era, where investors need outside auditors to verify key information.

Banks and their examiners should require a certified and annually updated statement by an outside auditor that the subject fund has never engaged in any such double-counting.

As part of my recommendations to the regulators on this issue, I suggested that, in the event that even one such case of double-counting is found at any fund — going back to the very first allowed investment in it — the examiners should not only deny CRA credit and publicly report their findings, but also require the fund to inform current and past investors of this problem.

Outside auditors should likewise verify other CRA-credit-related claims by funds or their managers such as community development benefits. They may, for example, be overstated by claiming credit for an entire project rather

than just the pro rata share from the fund's investment.

Also, current credit may be claimed for past investments that were sold or only temporarily held. Exaggerated community impact statements or double-counting results in CRA grade inflation, a mischievous malady that is not unlike bond rating inflation.

One way banks can help ensure they are getting the CRA or other investment promised is to perform their own due diligence when selecting a vendor. To help banks minimize risks when relying on third parties for such important products, the Federal Deposit Insurance Corp. recently issued "Guidance for Managing Third-Party Risk" (<http://www.fdic.gov/news/news/financial/2008/fil08044a.html>).

The FDIC recommends ongoing comprehensive due diligence in what can be termed its Know Your Vendor program. As part of the "review of all available information" about third parties to minimize reputational and other risks, the FDIC recommends, among other things, checking for the "existence of any significant complaints or litigation, or regulatory actions against the company."

Suggested online resources include the Federal Financial Institutions Examination Council (www.FFIEC.gov) and the Securities and Exchange Commission (www.sec.gov or www.AdviserInfo.sec.gov).

For example, an "Investment Adviser Search" at the latter site under the Madoff firm's name would have revealed a 2005 regulatory action resulting in a censure and fine, which may have at least raised a red flag to inquiring investors.

A final lesson we have learned from the current crisis is that due diligence on investments and their vendors is important not only to protect the value of investments, including CRA credit where appropriate, but also the bank's reputation when dealing with vendors. Recent reports about some conflicted community groups and their role in the subprime crisis suggest that banks likewise consider that source of potential reputational risk.

CRA is being unfairly blamed for many of the problems associated with the subprime crisis, and it would add insult to injury if some funds and/or their managers are inflating CRA investment credit. Bankers and especially regulators must be vigilant to make sure this does not happen.

Mr. Thomas is a CRA consultant, the president of Branchlocation.com of Miami, a lecturer in finance at the University of Pennsylvania's Wharton School, and author of "The CRA Handbook."

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