HOUSE
RESEARCH
ORGANIZATION bill analysis | 3/21/2007 | HB 944
Solomons
(CSHB 944 by Solomons)

SUBJECT: Prohibiting certain state bank branches at commercial affiliate locations

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 6 ayes — Solomons, Flynn, Anchia, Anderson, McCall, Orr

0 nays

1 absent — Chavez

WITNESSES: For —John Heasley, Texas Bankers Association, Karen M. Neeley, Independent Bankers Association of Texas; *(Registered, but did not testify:* Daniel Gonzalez, Texas Association of REALTORS)

Against — None

On — James S. Randall, Texas Department of Banking; *(Registered, but did not testify:* John C. Fleming, and Danny Payne, Texas Department of Savings and Mortgage Lending)

BACKGROUND: The Finance Code regulates the establishment of new financial institution branches. Sec. 32.203 provides that a state bank may establish and maintain a branch office at any location on prior written approval of the banking commissioner.

Under sec. 92.063, the savings and loan commissioner may permit a savings bank to establish additional offices in this state or another state or change its name in accordance with rules of the Finance Commission.

Sec. 203.002 establishes standards by which out-of-state banks may establish new branches in Texas. Under these standards, an out-of-state bank may establish a new branch if:

- the laws of the home state of the out-of-state bank would permit a Texas bank to establish and maintain a branch in that state under similar terms and conditions;
- the out-of-state bank confirms it will comply with all applicable laws of this state;

- the applicant provides satisfactory evidence of compliance with applicable requirements; and
- the appropriate officials certify to the responsible federal bank supervisory agency that the requirements of the Finance Code have been met.

DIGEST: CSHB 944 would prohibit a state bank from establishing or maintaining a branch on the premises of an affiliate that engages in commercial activity. Savings banks and out-of-state depository institutions insured by the FDIC could not establish or maintain a branch on the premises of an affiliate that engaged in commercial activity, but they could establish additional offices in this state or another state or change names with the permission of the savings and loan commissioner and in accordance with Finance Commission rules.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2007.

SUPPORTERS SAY: CSHB 944 would provide an important reinforcement of the division between commerce and banking. The bill would help safeguard against the concentration of power current federal and state law permits. Since the bill would affect only a narrowly defined subset of financial institutions, it would have minimal unintended consequences.

The federal Gramm Leach Bliley Act of 1999 eliminated some of the barriers between different types of financial institutions while retaining the principal division between commercial and banking activities. It did not, however, bar commercial enterprises from establishing and operating industrial loan corporations (ILCs). ILCs are financial entities chartered by a state and insured through the FDIC that are able to engage in certain banking practices, including the issuance of consumer loans, credit cards, and savings accounts.

The fusing of commercial and banking interests as embodied by recent ILC bank applications could give rise to a number of potential financial hazards. The commercial affiliate could drain a bank of capital or create incentives toward reckless lending in its own interests. A bank could become too exposed to loans to parent and affiliate customers. Troubled banks could jeopardize the financial stability of parent companies. Banks could be used to shore up losses in commercial activities.

ILCs are subject to fewer regulations than normal financial institutions. Bank holding companies are regulated by the Federal Reserve Bank (FED), which sets standards for financial activities that are non-commercial in nature. ILCs, on the other hand, submit applications with the FDIC for insurance after being chartered by states. This creates an unfair advantage when ILCs are paired with powerful corporate partners because it permits the benefits of FDIC insurance without subjecting a parent company to the strict regulatory standards imposed by the FED.

This situation could create a severe liability for taxpayers and consumers, who would assume the burden of financial failures caused by under-regulated commercial ILC relationships. While ILC failures are rare, they can be very costly. The failure of a California ILC — Southern Pacific Bank in 2003 — cost taxpayers $63.4 million. The impact of failures would be magnified greatly if ILC banks were established and maintained by major corporate actors like Home Depot, which currently has an ILC application pending at the FDIC.

While the FDIC application process is important, it cannot sufficiently account for changes over time. Many applicants claim to have narrow business plans that do not include expansion into operating bank branches. Yet over time these plans are subject to change, and there is no regulatory mechanism in place that would restrict future expansion to more traditional banking services.

CSHB 944 would establish one small but important safeguard against the dangers posed by expansive ILC growth. The bill's prohibition of locating banking activities on the premises of an affiliate would provide a simple yet effective means of protecting consumers against conspicuous abuses of the ILC loophole. The bill would not prohibit commercial enterprises from using ILCs that operate remotely — such as the arrangement Target has to process credit and debit transactions — but it significantly would hamper a commercial establishment from using an ILC to finance purchases at their store.

While legislation that would change the ability of commercial enterprises to operate ILCs is pending in Congress, there is no way of knowing when such legislation might pass and what form federal law ultimately would take. In the meantime, Texas can protect its consumers against the greater dangers posed by commercial ILCs through the simple, proactive measures contained in CSHB 944.

OPPONENTS SAY:

Any legislation negatively affecting the potential for commercial business to utilize the benefits of ILCs could place U.S. retailers at a competitive disadvantage. ILCs have become increasingly common and were associated with more than $140 billion in assets in 2004. As of January 31, 2007, there were 58 ILCs operating in seven states. The widening scope of how ILCs can be used represents an important innovation in financial services. ILCs offer many commercial enterprises the flexibility they require to enhance the efficiency of consumer transactions and compete against the strong international and domestic pressures to increase profits and expand business operations. In the retail industry, ILCs represent an important means of enhancing competitiveness by reducing unnecessary charges to the customer.

HB 944 would be a roundabout and ineffective attempt to regulate ILCs that would apply only to ILC applicants intending to set up branch banking at their stores. This is not the case with Home Depot's ILC application in Utah, nor was it part of Wal-Mart's plan to charter an ILC in that state before recently announcing that it would withdraw its application for FDIC insurance. Wal-Mart intended to establish an ILC to help reduce transaction costs, and Home Depot is attempting to purchase an existing ILC, EnerBank, to facilitate transactions between contractors and clients at its stores. CSHB 944 would add another statewide financial regulation, but would not have a clear impact on the growth of ILCs or the ability of the state to regulate their activities.

NOTES:

The committee substitute modified the bill as introduced to specify that savings banks and out-of-state depository institutions could exercise the privileges granted them under Finance Code, sec. 92.063(d).

A related bill, HB 341 by Leibowitz, which would place similar restrictions on the location of ILCs, is pending in the Financial Institutions Committee.