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October 10, 2006

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington D.C. 20429

ATTN: Comments

Re: Industrial Banks

Dear Mr. Feldman,

This letter is submitted by the Utah Association of Financial Services and the California Association of Industrial Banks in response to the request for public comment on industrial loan corporations issued by the FDIC on August 29, 2006. The organizations presenting this letter are trade associations whose members include industrial banks in California, Utah and Nevada.[1] We appreciate the opportunity to provide this information and believe the FDIC will determine the content to be beneficial. Our responses to the questions are as follows:

1. *Have developments in the ILC industry in recent years altered the relative risk profile of ILCs compared to other 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?*

History

The FDIC and state regulators, particularly the Utah Department of Financial Institutions and the California Department of Financial Institutions, have intensively

[1] Thrifts in Nevada have not formed a separate trade association. The Nevada banks that are members of a trade association have joined one or both of the associations in Utah and California. Members of these associations are listed on pages 39-41.

regulated and refined their regulatory oversight of industrial banks during the past several years. The Nevada Financial Institutions Division has also been active in licensing and regulating thrift companies, which is the equivalent of an industrial bank charter in that state.

Since at least 1987, the FDIC's publicly stated position on industrial banks has consistently included the following:

- Industrial banks present no greater risk to the deposit insurance fund than any other type of bank.

- The FDIC and state regulators have sufficient authority to adequately regulate and oversee industrial banks and other types of banks whose affiliates are not regulated under the Bank Holding Company Act.

- Banks can be successfully regulated in a way that insulates them from risks associated with non bank affiliates utilizing a unified regulatory system.

- The Bank Holding Company Act is not needed to ensure the safety and soundness of the banking system or the payments system and should be abolished.

These conclusions are supported by over twenty years of accumulated experience regulating an industry that has grown to over $160 billion in assets nationwide. Other than the political controversy relating to two recently filed industrial bank applications, we are aware of no developments that would alter or adversely affect the FDIC's positions regarding industrial banks as described above or raise any new question about whether there is a need for consolidated regulation of industrial bank affiliates by the Federal Reserve.

Since their inception, the FDIC has studied the development of industrial banks and other limited purpose and non-traditional depository institutions operating outside the purview of the Bank Holding Company Act along with their holding companies and affiliates. In 1987, the FDIC published a detailed study of the regulation of holding companies and bank affiliates titled "Mandate for Change". The study called for a restructuring of the regulatory system along the lines of the regulatory model used today by the FDIC and state regulators to regulate the industrial banks and other non traditional banks and their affiliates.

This regulatory model, which the FDIC describes as "bank centric", unifies regulation under the bank's regulators to oversee the bank, its subsidiaries, its parent company and its affiliates. Regulation of affiliates focuses on transactions and relationships between the bank and its affiliates, not matters irrelevant to the bank. In contrast, the model used by the Federal Reserve to regulate bank holding companies and affiliates under the Bank Holding Company Act (referred to in this letter as "traditional bank holding companies") bifurcates regulation utilizing a separate and independent regulator—the Federal Reserve—to oversee the bank's parent company and affiliates.

The traditional bank holding company model also extends regulation to everything a parent company or bank affiliate does even if it is not relevant to the bank, a program that works better in that context than others because traditional bank holding companies and affiliates typically do not engage in activities unrelated to the bank.

The key conclusions of the Mandate for Change were summarized in the following excerpt:

> . . . [T]here appears to be no historical precedent to suggest that there is a long-standing tradition of separation of banking and commerce in the United States. Beyond historical precedent, our review of the evidence does not support the wisdom of separation and thus we find no compelling reasons for continuing it.
>
> Perhaps most importantly, the analysis does not support the view that product limitations and regulatory or supervisory authority over non banking affiliates of banks are necessary to protect the stability of the system or to limit the exposure of the deposit insurer or the payments system. There is evidence that insulation from risks from any type of affiliate can be maintained with relatively few changes to current rules governing the operations of banks and, most importantly, the professional supervisory staff of the FDIC concurs with this view.
>
> From a public-policy perspective, the implications are clear. If a regulation is not necessary, economic efficiency will be enhanced if the regulation is eliminated. . . . Neither the Glass-Steagall separation of commercial and investment banking nor the Bank Holding Company Act appear to be necessary to the safety and soundness of the banking system.
>
> . . . The removal of constraints is appropriate if we can insulate the banking entities from the risks associated with non bank affiliates, without spinning a regulatory web around the entire organization.
>
> The major conclusion of this study is that insulation can be achieved, with only minor changes to existing rules pertaining to the operations of banks. Thus, systemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over nonbank affiliates are abolished.
>
> The public policy implication of this conclusion is that certain provisions of the Bank Holding Company Act and the Glass-Steagall restrictions on affiliations between commercial and

> investment banking firms should be abolished. . . . *Mandate for Change, pages 98 and 101 to 102.*

As advocated by this study, the Glass-Steagall Act was repealed in 1999. In addition, Congress repealed virtually all of the geographic and branching restrictions in the Bank Holding Company Act after this study was published. (As originally drafted, the BHCA enforced state laws limiting ownership or operation of banks in more than one state). Only the restrictions on commercial activities, tying, and so-called "consolidated" regulation of non bank affiliates, remain in the law. (Although the Mandate for Change called for repeal of the remaining provisions of the Bank Holding Company Act, the industrial banks do not advocate repeal of the anti-tying provisions, which we believe should be retained and continue to apply to all banks.)

In his September, 2005 reply to a report by the GAO regarding industrial banks and bank holding company supervision, former FDIC Chairman Donald E. Powell reaffirmed the FDIC's current regulatory standards and procedures, its support for a unified system to regulate holding companies and affiliates, and the elimination of consolidated regulation of bank affiliates. In pertinent part, the letter said:

> . . . the FDIC does not believe that consolidated supervision of an ILC's corporate owner is necessary to ensure the safety and soundness of the ILC itself. The FDIC disagrees with the GAO's finding that our regulatory authorities may not be sufficient to effectively supervise, regulate, or take enforcement action to insulate insured institutions against undue risks presented by external parties.
>
> . . . The FDIC believes that bank-centric supervision, as applied by the National Bank Act and the FDIC Act, and enhanced by Sections 23A and 23B of the Federal Reserve act and the Prompt Corrective Action provisions of the FDIC Improvement Act, is a proven model for protecting the deposit insurance funds, and no additional layer of consolidated federal supervision of ILC parents is necessary.

The Mandate for Change recommended that the Bank Holding Company Act be repealed in phases to ensure that it did not inadvertently adversely affect the economy, the banking industry or the regulatory system. The same year the Mandate for Change was published Congress enacted the Competitive Equality Banking Act of 1987 ("CEBA"), which expressly exempted affiliates of industrial banks from the Bank Holding Company Act, except the anti-tying provisions. The development of the bank centric model to regulate industrial bank affiliates over the past twenty-plus years became the experiment proposed by the Mandate for Change in 1987. That experiment has been an unequivocal success. The correctness of the conclusions and recommendations of the Mandate for Change are now well documented by the accumulated record of the industrial bank industry. Among other facts:

- By every objective measure, industrial banks are among the strongest, safest and soundest banks the FDIC has ever insured. Capital ratios for Utah industrial banks are nearly double the average for banks generally.

- Unique features of the industrial bank model together with Sections 23A and 23B of the Federal Reserve Act and anti-tying provisions of the Bank Holding Company Act have proven effective in regulating relationships and transactions with affiliates and insulating banks from affiliation risks generally.

- Diversified holding companies are often able to provide a higher level of support to a subsidiary bank than a traditional bank holding company.

- The bank centric regulatory model fits well with the modern financial services markets.

- The traditional bank holding company model is outdated and conflicts with the needs of modern financial services providers.

No substantial problems or deficiencies have developed in the bank centric regulatory model or the FDIC's policies and practices regarding industrial banks during the past twenty years. This record of success is completely at odds with the numerous allegations of inadequate regulation asserted by industry critics. In reality, the controversy over industrial banks is political in nature and has nothing to do with problems in the industry or potential flaws in the bank centric regulatory system.

Regulation of industrial banks and their affiliates

Industrial banks are subject to the same laws and standards applicable to all banks. In addition, Utah industrial banks are subject to special requirements designed to ensure competent and independent control of the bank. Laws governing affiliate transactions applicable to all banks have proven effective to protect a bank from undue risk.

Section 23A adequately defines transactions with affiliates and eliminates risks to the bank when engaging in those transactions. By requiring all covered transactions to be secured by a cash deposit or government securities, or to be sold without recourse, Section 23A prevents a bank from using deposits to fund transactions with an affiliate. In practice, this means that a commercial holding company can organize a bank to finance transactions with an affiliate only if the parent or another party absorbs all risk.

Section 23B ensures that all transactions with affiliates are on terms equivalent to a transaction with a third party or are fair to the bank if third party comparisons are not available.

The anti-tying laws and Section 23B together prohibit a bank from offering discounted rates and terms or other incentives to engage in transactions with affiliates.

The overall intent of these laws is to prevent a bank from financing, benefiting or promoting an affiliate - even when not detrimental to the bank - except through the payment of dividends to the bank's parent.

Industrial banks, like all other banks, cannot pay any dividend or make any distribution that would be unsafe or unsound for the bank. To ensure that the payment of dividends does not impose a risk to the bank, industrial banks are allowed to only pay a dividend out of undivided profits or retained earnings after the board of directors has determined that the bank will remain adequately capitalized and will have sufficient capital to support anticipated growth after payment of the dividend.

The bank centric regulatory model has evolved over the past twenty years into a robust, comprehensive and effective regulatory model. Many of the unique features of the model relate to the fact that industrial banks can have more extensive affiliate relationships than traditional banks and would benefit from stronger controls over those relationships. That resulted at the outset in an emphasis on independent control of the bank to help ensure that it complies with the affiliate transaction laws. Unlike other banks, industrial banks are required to have strong independent boards, independent audit committees and highly qualified management dedicated to the bank alone.

The board of an industrial bank is expected to have a minimum of five members, the majority of which must be outside directors with no connection to an affiliate of the bank. These outside directors are expected to have special expertise in accounting, regulation, banking or the kind of business the bank will conduct. All directors are expected to receive ongoing training on the duties of a bank director, often at training sessions conducted by the FDIC and bank trade associations.

The audit committee must consist solely of outside directors and be chaired by an individual with accounting, auditing or regulatory experience who is qualified to oversee the audits of the bank. The audit committee has the sole authority to select the bank's auditors and all audit reports are made to the committee.

Each bank officer must have prior successful experience in the position he or she will perform. Most industrial bank officers joined the bank after a long and successful career in commercial banking or regulation. The boards and management of most industrial banks are as strong as any banks in the nation.

Comparison between unified and traditional bank holding company regulation

The bank centric regulatory model has proven effective in controlling relationships and transactions between banks and their affiliates. The primary difference between the bank centric and traditional bank holding company models is the extent to which the regulation is unified and coordinated, not the extent to which the affiliates are regulated.

The term "consolidated" is a misleading characterization of regulation under the Bank Holding Company Act. In reality, traditional bank holding company regulation is divided among different regulators and is neither consolidated nor coordinated. The bank has one group of regulators, either the OCC, or a state regulator and the FDIC (if the bank is a non member), or a state regulator and the FRB (if the bank is a member), while the holding company and all non bank affiliates are regulated independently by the Federal Reserve. Unless the bank is a state member bank, the two regulatory groups do not work together or routinely coordinate on regulatory matters. If the bank regulator finds a problem at the bank involving the holding company or affiliate, it must work through the FRB to resolve the issue. This form of regulation is inherently disjointed and inefficient.

Under the bank centric model, the bank's regulators regulate the relationship and transactions between the bank and its affiliates in conjunction with their regulation of the bank. Contrary to common assertions about the inadequate regulation of industrial bank affiliates, the FDIC's authority over such affiliates, when combined with the authority of the corresponding state regulator, is comparable to the FRB's authority over bank holding companies in all material respects. The FDIC and state regulators can:

- Impose prudent limitations on transactions with affiliates and other safeguards in orders approving applications or as recommendations in examinations.
- Examine all affiliates that control or engage in transactions with the bank.[2]
- Require production of information from any affiliate about any activity affecting the bank.
- Issue cease and desist orders enforceable in court against affiliates and other institution affiliated parties regarding any activity that actually or potentially affects the bank.
- Ban any institution-affiliated party from further involvement with the bank.
- Assess civil money penalties against any affiliate or institution-affiliated party.
- Terminate the holding company's control of the bank by taking possession of the bank and liquidating or merging it.

[2] In practice, holding companies and affiliates usually provide any information requested by the bank's regulator. In addition, most industrial bank affiliates are publicly traded companies and most germane information is readily available and examined today as part of FDIC examinations.

This system is proven effective and more logical and efficient than traditional bank holding company regulation. Whenever an issue arises involving a holding company or affiliate, the bank's regulators can deal with it directly in coordination with actions taken at the bank.

A less significant feature of the unified model is that it does not assert jurisdiction over affiliates or operations that have no involvement with the bank. The FRB and GAO assert that this poses a danger to the bank but no one advocating that view has cited any instance where an affiliate whose only connection with the bank is common ownership caused a problem or posed any identifiable risk to the bank or given any credible reason why such an incident might occur. We believe this argument is unfounded and primarily intended to preserve the Federal Reserve's role in holding company regulation. Any affiliate whose activities affect or might affect the bank can be regulated by the bank's regulators. Activities of affiliates not affecting the bank are by definition not relevant.

The current debate over consolidated regulation and affiliate activities often overlooks the fact that affiliation with a diversified holding company has proven more of a benefit than a risk to industrial banks. Many industrial banks are a relatively small part of a larger group that can provide more financial, marketing and operational support to the bank than any bank holding company and most financial holding companies can provide to a traditional bank. In some cases, the cost of an industrial bank's initial capitalization is not even material to the parent's financial statements and the parent could easily infuse new capital whenever needed, even if the bank suffered the most catastrophic losses possible. Just as important, parents and affiliates, usually supply all of an industrial bank's business so the bank has little or no marketing expense or risk. Most industrial banks are organized to take over an existing financial services business and run it more efficiently and profitably.

In contrast, a typical bank holding company is a relatively weak organization that provides little financial or marketing support to its bank subsidiary. The holding company can only own a bank and entities engaged in related activities. It makes no economic sense to hold large amounts of cash or permissible investments apart from the bank so the typical bank holding company has few assets except the bank. When the bank needs new capital, a traditional holding company must usually raise it through a new securities offering, which is difficult if the bank is in trouble. As a result, a bank holding company is almost always irrelevant if a bank is failing. Hundreds of banks owned by bank holding companies have failed during the past twenty years and the only instance we are aware of when a bank holding company saved a failing bank subsidiary is when the holding company owned other banks that could absorb the parts of the failing bank without failing themselves.

Additionally, a traditional bank holding company rarely provides any business to a bank subsidiary. As an isolated entity, a traditional bank must develop its own business, often from scratch. In contrast, many industrial banks begin as a fully developed business. They only need to manage the business provided through the parent company.

Large financial holding companies can often provide more support to their subsidiary banks than a traditional bank holding company but that is because financial holding companies are typically more diversified than a traditional bank holding company. In that respect, many financial holding companies resemble industrial bank holding companies more than traditional bank holding companies. However, the ways in which financial holding companies still resemble traditional bank holding companies makes them unworkable or a less desirable choice for many bank organizers today.

Affiliation with a large diversified holding company has provided other benefits to industrial banks. Most of the parent companies are publicly traded and prominent in their particular markets. Most bank officials report being told at their first meetings with parent companies that first and foremost they must do never to anything to discredit the "brand". For many of these companies, their brand is their primary asset. Shareholders reinforce this message because they know the impact that negative events can have on the value of their investments. A bank failure or problems with bank regulators aired publicly would be alarming to the markets in most cases. Although the risks of affiliations must never be downplayed, especially in a holding company in financial trouble, the power of market discipline and concerns about reputation risk must also be recognized as a strength that significantly enhances safety and soundness in many instances.

This high level of support provided by the parent and affiliates of most industrial banks is one of the primary reasons why those banks are generally stronger and safer than banks owned by traditional bank holding companies.

Even when a bank's parent company is not strong, the bank centric model has proven its effectiveness. Each industrial bank is independently controlled and required to hold only bank quality assets. In the past thirty years, only two FDIC insured industrial banks have failed. Both were located in California. One failed when a portion of its derivatives assets were revalued. That failure resulted in revamped accounting rules for derivatives for all banks. The other was a bank that failed mostly due to loan losses in subprime mortgage loans and the impact on an airplane leasing portfolio when travel declined in the aftermath of the destruction of the World Trade Center towers.[3] No other FDIC insured industrial bank has become insolvent, even when the parent company of one Utah industrial bank declared bankruptcy. In that instance, the parent company's problems affected the flow of business to the bank and the bank decided to close. The bank was able to sell its portfolio for a premium, pay all of its depositors and other creditors in full and still had enough left over to pay a substantial liquidating dividend to the bankruptcy trustee of the parent company. This record of industrial bank failures is much better than for banks owned by bank holding companies.

[3] Utah and California industrial banks have different characteristics. The Utah banks are mostly specialized lenders serving a nationwide market. All of the Utah industrial banks do more than 95% of their business out of state. The California industrial banks make most or all of their loans to customers in California.

Industrial banks have also proven to be less at risk of a liquidity crisis when there are problems with a parent or affiliate. Industrial banks do not take demand deposits and only a few offer NOW accounts. In most cases, deposits are brokered. Most depositors don't know their deposits are held by a particular industrial bank so the risk of a run is minimized. In the instance cited above where the bank's parent declared bankruptcy, there was very little outflow of deposits other than those that had matured or were paid out by the bank itself as it liquidated itself.

Characteristics of industrial banks

Industrial banks with an operating parent company mostly conduct independent financial services operations or offer bank products and services to existing customers of the bank's parent and affiliates. They usually do not finance transactions with affiliates and are highly restricted when they do.

Many industrial banks are core businesses in themselves or parts of a core financial services business within a larger corporate group. These banks compete directly with other banks for business with unaffiliated third parties and are mostly indistinguishable from other banks in terms of their structure and programs. Their affiliation with other divisions that engage in non financial activities is mostly circumstantial and unrelated to the activities of the affiliates.

Another group of industrial banks leverage existing customer relationships with affiliates. This is a common and logical way to build many kinds of businesses. Often customers demand those services because they want the convenience and economic benefits of one stop shopping for all of their financial needs.

For example, many securities companies organized banks in response to demands by investment banking clients for a full range of financial services including debt financing in addition to securities underwritings. This is the same market pressure that resulted in the repeal of the Glass-Steagall Act in 1999, but in that instance the effort to repeal the law was led by large bank holding companies whose banking customers were demanding securities underwriting services.

One of the best examples of the power of leveraging existing customer relationships occurred during the darkest days of the savings and loan crisis. That crisis affected savings and loans in Texas more than in most other states. At one time two thirds of the savings and loans in Texas had failed or were failing. The crisis was only exceeded by the Great Depression. In the midst of this carnage, one large Texas based federal savings bank stood out because of its high ratings for financial strength, good management and customer satisfaction. This was mostly as a result of its affiliation with a large insurance company. That insurance company did not initially plan to expand its product offerings beyond insurance but it received many requests in customer satisfaction surveys for banking products, mutual funds, and other financial services. Those requests prompted it to organize a federal savings bank because at that time the Bank Holding Company Act did not allow an insurance company to own a commercial bank. The bank's first product offering was a MasterCard credit card that offered no rewards or incentives for use or discounts on insurance or other products and services offered by its affiliates. In a typical credit card mailing, a one percent response is considered successful. This bank thought it might do better because it was dealing with its affiliate's insurance customers so it prepared for a 10% response to its first mailing. It sent 250,000 invitations to apply for a card and was nearly overwhelmed when it got a 48% response. Unlike 80% of the savings and loan associations in Texas in 1980, that bank still operates today offering high demand and high quality products to its affiliate's customers. This is just one of many examples where the restrictions in the Bank Holding Company Act arbitrarily bar competent and highly successful financial services providers from the banking industry and serve more as a barrier to the benefits of affiliation than a control over any inherent risk.

The kind of marketing power illustrated in this example is a paradigm of our market economy and one of the primary forces driving the development of the industrial bank industry. Until thirty years ago, most businesses had little interest in owning a bank because of capital constraints and geographic limitations on bank operations. Since then, new technology and the elimination of geographic restrictions created new opportunities for many businesses to enter the financial services markets. The development of financial services during this period has been unprecedented. Today, the U.S. economy is the most diverse and innovative producer of credit and other financial services in history. Within the overall financial services market, financial services providers operating outside the scope of the Bank Holding Company Act may now provide most of that credit.

A growing number of diversified financial services providers want access to a depository charter because it is often the most efficient way to run their financial services businesses. These companies are the backbone of the economy, not a fringe. They are highly competent and in many cases they invented the financial services they offer and know more about that market than anyone. The industrial bank charter serves the public needs and convenience by providing a depository institution option for those companies.

The array of industrial banks operating today can be partially summarized as follows:

- *Banks owned by securities companies.* These banks hold about 80% of the industry's current assets. Some are depositories for idle funds swept from brokerage accounts. They also provide commercial loans and consumer credit for brokerage customers. In most cases, the parent operates under consolidated regulation by the SEC and in many cases by the OTS as well. These banks include Merrill Lynch Bank USA, UBS Bank USA, Lehman Brothers Commercial Bank, Morgan Stanley Bank, and Goldman Sachs Bank USA.

- *Banks owned by commercial finance companies.* Many industrial banks are owned by parents that are established commercial lenders. Some offer small business loans while others serve medium size businesses that have become underserved due to consolidation of medium size and regional commercial banks.

These banks include Advanta Bank, American Express Centurion Bank, Capmark Bank, Escrow Bank USA, LCA Bank, Medallion Bank, World Financial Capital Bank, Wright Express Financial Services Corp. and CapitalSource Bank (application pending).

- *Banks owned by consumer finance companies.* These banks primarily offer credit cards and other traditional consumer financial services. These banks include American Express Centurion Bank, Merrick Bank and Sallie Mae Bank.

- *Banks owned by a commercial company conducting an independent core financial services business*. These banks are owned by a corporate parent with other subsidiaries engaged in non banking activities but the bank typically conducts its own financial services operations as an independent core business. Most banks in this group compete directly with other banks for business with unaffiliated parties. Banks in this group include GE Capital Financial, CIT Bank, Community Commerce Bank, EnerBank and American Pioneer Bank (application pending).

- *Commercially owned banks offering financial services to customers of the corporate group that are not affiliate transactions.* These banks typically market traditional financial services to customers of an affiliate. However, these are not covered transactions under Section 23A of the Federal Reserve Act because the bank does not finance transactions with an affiliate. Instead, it takes advantage of marketing opportunities and convenience to offer separate and independent banking products and services to customers of the corporate group. For example, one bank offers traditional banking services to truckers, including independent owner operators. The bank is owned by a company that operates truck plazas across the nation. The affiliation facilitates marketing of financial products to truckers and providing access to banking services at each truck stop. This bank is helping to serve unmet and underserved needs in innovative ways no unaffiliated bank could or is willing to do. Banks in this group include Allegiance Direct Bank, BMW Bank of North America, Eaglemark Savings Bank, GMAC Automotive Bank, Pitney Bowes Bank, Toyota Financial Savings Bank, Transportation Alliance Bank, USAA Savings Bank, Volkswagen Bank USA and Daimler Chrysler Bank (application pending).

- *Banks owned by a commercial company that finance transactions with affiliates subject to the restrictions in Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act.* These banks originate loans to finance transactions with affiliates but all of their loans are secured dollar for dollar by a cash deposit in the bank or U.S. Government securities, or the loans are sold without recourse. In addition, the loans must be offered on market terms and do not involve any incentive to engage in transactions with the bank's affiliates. These banks provide advantages mostly for retailers in terms of convenience, standardized nationwide programs, and exemption from licensing in multiple states. For reasons described above, compliance with Section 23A effectively means the banks cannot utilize deposits to fund transactions with any affiliate. Because they have no risk of loan loss, these are perhaps the safest banks that currently exist. Banks in this group include Target Bank and First Electronic Bank.

- *Banks owned by title insurance holding companies.* These mostly California based industrial banks are owned by publicly traded and state licensed title insurance companies with financial services subsidiaries including industrial banks. Banks in this group include Centennial Bank and First Security Thrift Company.
- *Independently owned banks*. These banks are not affiliated with a large corporate group and either have no holding company or a holding company with no other substantial businesses. Some of these banks are owned by diversified investor groups or have significant investors that do not directly engage in any business other than investing, such as mutual funds and both public and private equity funds. Banks in this group include Celtic Bank, Fremont Investment & Loan, Magnet Bank, Republic Bank and WebBank.

Characteristics of the financial services market

The structure of the financial services markets primarily determines the structure of the regulatory system at any point in time. That is because regulators serve the market, not vice versa. The regulator's role is to ensure that the markets and the companies providing banking services are safe, honest and fair. Because of the dominant role played by the market, a good fit between the market and the regulators is essential to the efficient and effective functioning of the regulatory system.

Intensive market pressure, not any agency study or legislative initiative, prompted Congress to repeal provisions in the Bank Holding Company Act prohibiting affiliations between investment and commercial banks, to allow banks to operate across state lines, and to set up a legal structure to allow interstate branching. Those reforms were primarily driven by bank holding companies that had to amend the Bank Holding Company Act to achieve their legitimate development goals.

The development of the industrial banks is likewise driven by intense market forces. Specifically, it is a direct result of a growing number of companies throughout the economy that need access to a depository charter to pursue opportunities to provide new financial services or provide existing financial services operations more efficiently and cost effectively. An industrial bank is also the charter of choice for many financial services providers that prefer unified regulation because it is more logical and efficient than the Federal Reserve's separate regulation of traditional bank holding companies.

Companies in this segment of the market can achieve their goals under the exemption from the Bank Holding Company Act for industrial bank affiliates that Congress enacted in CEBA and do not need to amend the Bank Holding Company Act like bank holding companies were forced to do. That is why the affiliate activities provisions of the Bank Holding Company Act have not been intensively challenged before now.

Nevertheless, the success and growth of the bank centric regulatory model has become an indirect and growing threat to the traditional bank holding company model. The defenders of the traditional model feel that they need to attack the bank centric model as unsafe and inadequately regulated to prevent it from becoming an established alternative to the traditional model, one that could easily become the dominant model in time. This is a tacit acknowledgement that the Bank Holding Company Act structure cannot stand on its own merits. It will only survive if it is compulsory for all bank owners. It is also conspicuously anti competitive. But because the traditional bank holding company model is increasingly in conflict with the market, we believe it cannot survive, at least not as a compulsory system, over the long term.

As applied by the Federal Reserve, the principles of consolidated regulation conflict with the needs of the market. It is increasingly apparent that those requirements, particularly the restrictions on activities of affiliates, are unnecessarily burdensome. As former Federal Reserve Chairman Alan Greenspan admitted in Congressional testimony, consolidated regulation does not make sense if the bank is not the primary asset in the corporate group. Bank regulators have no realistic ability to regulate an affiliate engaged in commercial activities. Of course, that does not rule out the option of scaling the holding company regulation down to a degree similar to that utilized under the bank centric model, but that would undermine the logic for a separate regulator.

That is why defenders of the traditional holding company regulatory model argue that consolidated regulation is necessary for the safety of the bank. If they can sell that notion—even though there is no evidence to support it—they can carry the argument further to say that consolidated regulation works only if affiliates engage solely in activities capable of being regulated by the Federal Reserve.

In reality, no case can be made for denying diversified companies access to a depository charter in today's market. The market today is safely, soundly and prudently taking financial services to a new level that among other things is positioning the U.S. to become the leading provider of financial services to the world. These trends are increasingly in conflict with the activities restrictions in the Bank Holding Company Act. Since the success of any bank or other financial services provider is determined by the market, not the Federal Reserve or any other regulator, the needs and trends in the market must prevail for banks to achieve maximum success.

The supporters of the Bank Holding Company Act and its bifurcated regulatory structure ignore the fundamental importance of the markets and will damage the markets if their goal to monopolize holding company regulation is achieved. The FDIC should be commended for recognizing the needs of the market and providing safe and prudent options for today's financial services providers.

With this background, we believe the FDIC has closely followed the development of the industrial bank industry and developed a regulatory model that effectively supervises the industry and its affiliates. The only recommendations we would make are the following:

- It would be helpful for the FDIC to adopt a regulation based on current law setting forth how it regulates holding companies and affiliates. Collecting these authorities in one clear outline would educate banks and their affiliates and help dispel the misinformation about the FDIC's purported lack of adequate authority often mentioned in the current debates.

- The Federal Reserve excluded non-member banks from Regulation W. Although FDIA Section 18(j) (12 U.S.C. § 1828(j)) applies sections 23A and 23B to state nonmember banks in the same manner and to the same extent as if they were member banks, the exclusion of non member banks from Regulation W raises a question about the extent to which the provisions of Regulation W apply to a nonmember bank. The FDIC could resolve that question by adopting provisions interpreting and implementing Sections 23A and 23B for non-member banks in the regulation described above or in a separate regulation. (An alternative would be to have FFIEC develop a uniform interagency regulation for adoption by all of the member regulators).

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

We see no inherent difference between commercial and financial owners of an industrial bank with regard to the safety and soundness of the bank. All industrial banks are subject to the same standards, requirements and regulatory oversight as other banks. Both financial and commercial companies are major providers of financial services in the market generally and there is no evidence that either group presents more or less risk to the deposit insurance fund.

The separation of banking and commerce is widely misunderstood. It should be remembered that Congress thought it necessary during the Great Depression to totally separate commercial and investment banking through passage of the Glass-Steagall Act, but took no action to separate banking and commerce until 1956 and 1971. As the Mandate for Change noted, the Glass-Steagall Act was passed because of the popular but ultimately mistaken belief that the stock market crash was caused in part by margin lending by banks owned by securities firms. Few or no bank failures were caused by banks owned by commercial companies. On the contrary, the most prominent instance of banks owned by commercial companies during the Great Depression was when General Motors and Ford Motor Company provided the capital for new banks in Michigan to help restart the Michigan banking industry after it had collapsed in 1933. Ford backed the Manufacturers National Bank of Detroit and remained a shareholder until the 1950s. General Motors backed the National Bank of Detroit and remained its largest shareholder until the 1950s.

The passage of the Bank Holding Company Act in 1956, which initially covered single holding companies only, and the 1971 amendments that included multi bank holding companies, were not precipitated by any significant problems relating to commercially owned banks. Commercial companies had little interest in owning banks prior to the 1980s. The concern about mixing banking and commerce related to the fact that banks at that time were the primary providers of credit and separation helped ensure equal access to credit for all other businesses. It was also an opportunity for the Federal Reserve to enlarge its relatively marginal regulatory role in the banking industry. The restrictions incorporated in the Bank Holding Company Act came under increasing market pressure beginning in the 1980s as new technology created opportunities for diverse businesses to offer financial services as a core or add-on product. This also increased pressure to repeal the Glass-Steagall Act primarily because of the growing market demand for financial services companies that could provide a full range of services. The Mandate for Change concluded that the reasons for enacting the Glass-Steagall Act were mistaken from the outset and the law should be repealed, which it was due to intense pressure primarily from large bank holding companies in 1999.

Since the Bank Holding Company Act was enacted in 1956 and amended in 1971, the financial services markets have changed dramatically. Sources of credit have expanded throughout the economy and many of those providers can offer their products and services most efficiently and profitably through a bank. Today, entities including banks that are not subject to the Bank Holding Company Act may provide the majority of credit in the economy. In these new circumstances, separating banking and commerce is no longer necessary to ensure equal access to credit. Instead, the real issue today is whether all providers of high quality credit will be able to conduct their businesses in the most efficient and cost effective manner and, when offered through an insured institution, that it operates in a safe and sound manner.

Financial companies may be generally less likely to organize a bank to engage in covered transactions under Section 23A. They more often try to expand the range of financial services they offer their customers. The loans made by these banks are generally indistinguishable from loans made by a commercial bank.

Many commercial companies would like to organize a bank to finance purchases from the parent or another affiliate but do not pursue a bank charter after they become aware of the limitations on covered transactions imposed by Sections 23A and 23B and the anti-tying laws.

Some commercial companies have organized industrial banks to finance transactions with affiliates subject to the constraints in Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions in the Bank Holding Company Act.

These banks are organized by companies that do not need deposits to fund loans. To comply with the affiliate transaction laws, the bank either sells all of its loans without recourse, often to an affiliate, or each loan is secured dollar for dollar with a cash deposit in the bank. As a result, these banks have no risk of loan loss and for that reason may be the safest banks anywhere. The parent gains other advantages from organizing the bank such as exporting interest rates for nationwide loan programs, becoming an original issuer of Visa and MasterCard credit cards, and avoiding many state licensing requirements. Because they are so safe, there is no credible argument for restricting these banks because of potential risks to the deposit insurance fund, the banking system or the nation's economy.

Another group of commercially owned banks do not finance transactions with affiliates. They have core financial services businesses competing on equal terms with all other banks for business with unaffiliated parties. These banks are classified as commercial only because they have affiliates engaged in commercial activities that otherwise have no connection to the bank. For example, one industrial bank is owned by a successful specialty finance company that has a separate subsidiary involved in advertising. The advertising affiliate has no bearing on the operations of the bank and is simply irrelevant to the bank's safety and soundness. The loans made by these banks are generally indistinguishable from any other bank and present no greater risk to the deposit insurance fund than traditional banks.

A third group of commercially owned banks provide financial services to customers of an affiliate but these are not covered transactions under Sections 23A and 23B because the bank does not finance transactions *with* affiliates. Again, there is little or no inherent risk in these programs since the bank independently sets its own underwriting standards and ensures that its programs comply with all applicable laws. In most cases, the affiliation with a commercial parent provides a marketing advantage to the bank.

A good example is a bank that primarily serves truckers, which is a underserved industry. On the road truckers live at truck stops. They get showers and meals; buy groceries, and all of the other staples of daily life at the truck stop. One of their biggest challenges is access to financial services. No bank has a nationwide branch network and no bank has ever opened a branch or other office at a truck stop. Even if there were a nationwide bank, it is difficult for a trucker to search for a branch in an unfamiliar city and negotiate a big rig into a drive-up or branch parking lot.

A company that operates a chain of truck stops across the nation organized an industrial bank to serve this under banked group. This company has a truck plaza in every state and multiple plazas in many states. The bank has developed a system to provide a broad array of banking services to truckers on the road without establishing branches or having bank employees on site. This is accomplished with on line banking, ATMs, scanning machines, and telephone service centers. Scanning and fax machines are available at each truck plaza to send copies of bills of lading to the bank for factoring. If the bank purchases a bill of lading, the funds are deposited into the trucker's account at the bank. That secures a line of credit that can be accessed with a credit card at any ATM or by check. Each parent owned truck plaza is a Wi-Fi zone so truckers with their own portable computer can do on line banking to check balances, pay bills and transfer funds. If the trucker doesn't have a portable computer, one is available inside the truck plaza with people that can assist in operation. The bank's telephone service center is available to assist with opening new accounts, answering questions, resolving account problems, and all of the other services normally provided by a teller. The only service the bank cannot currently provide is accepting a cash deposit. For that, the trucker must purchase a money order and mail it to the bank.

The bank itself is well capitalized and profitable, and is a good example of the benefits that can be gained by the customers as well as the bank and its owner through an affiliation with a commercial parent. Factors such as these should be counted as a positive in terms of serving public needs and convenience when applications are reviewed by the FDIC.

This is typical of banks providing add-on services to customers of an affiliate and is a good example of the ways in which financial services are spreading through the entire economy, reaching people who have not been adequately served in the past and increasing the convenience for customers and providers alike. This is where the financial services markets are going and it is a desirable trend that should be supported, not inhibited by outdated and incompatible laws.

All of the industrial banks are real banks subject to the same standards and requirements of every other bank regardless of how the parent is classified. The risk profiles of all of these banks are generally the same as traditional banks. The exception is banks engaged in originating covered transactions subject to Section 23A and they present no risk of loan loss and hence are significantly less risky than traditional banks. That is why we believe no valid or meaningful distinctions can be drawn between banks solely on the basis of whether their owners are engaged in commercial or financial activities. It is far more important to look at the risk profile of the products and services offered by each individual bank.

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?*

There is no evidence that "consolidated" regulation reduces bank failures or produces stronger banks. It is clearly appropriate and beneficial to regulate the relationships and transactions between banks and their affiliates and to insulate the banks from risks relating to the affiliates, but that is accomplished as well under the bank centric regulatory model as under any bifurcated model involving another regulator of the holding company and affiliates.

There are actually several holding company regulatory models. In addition to the traditional bank holding company model administered by the Federal Reserve and state regulators, and the bank centric model administered by the FDIC and state regulators, there is the federal savings bank model and the SEC model. The primary difference between these models is who regulates the parent and affiliates, not whether they are regulated. Banks holding more than 90% of all industrial bank assets are owned by holding companies subject to some kind of consolidated regulation by the SEC or the OTS, and in some cases both the SEC and OTS. Some of those holding companies and affiliates are also licensed and regulated by state regulators.[4] But even in those cases, the FDIC has not deferred entirely to the separate consolidated regulator to regulate the relationships and transactions between the bank and its affiliates. Except for holding companies regulated under the Bank Holding Company Act, the FDIC routinely imposes conditions on industrial bank parent companies even if they are regulated by a consolidated regulator and directly enforces laws and regulations against affiliates if needed. It is functional, not territorial regulation. In that regard, it is worth noting that the bank centric model works very well with all other regulatory systems, even when there is overlap.

The only limit on the FDIC's jurisdiction over affiliates under the bank centric model relates to entities that have no connection with the bank other than common ownership. For example, the FDIC would not examine or otherwise intrude into the operations of the advertising company affiliate mentioned above as long as it has nothing to do with the bank. There is just no reason to do that. That means there can be no transactions between the two entities and no officer of the affiliate can be involved in the bank's operations. In those circumstances, the affiliate is as irrelevant as if it were totally independent.

In contrast, if the bank's parent were a bank holding company, it would not be allowed to own an advertising company. We believe that prohibition is excessive and unjustified. If an affiliate is irrelevant it has, by definition, no significance to the bank. There is no evidence suggesting that irrelevant affiliates must be regulated to ensure the safety and soundness of the bank. Nor is there any evidence that affiliates engaged in non banking activities pose any inherent risk to a bank.

With this background, we believe it is appropriate for the FDIC to consider the extent to which a holding company and affiliates will be regulated by another regulator and can provide support to the bank and impose conditions on the approval of an application if needed to ensure adequate regulation of affiliates when another regulator will not adequately cover a particular area. For example, in past orders approving applications the FDIC has imposed conditions on transactions with affiliate foreign banks

[4] In Utah, registration is mandatory for all industrial bank holding companies.

when the parent is not a bank holding company. In one case the FDIC prohibited the bank from engaging in any activity with a foreign bank affiliate without the prior approval of the FDIC.

Holding companies developing international financial services operations face a unique challenge if the holding company does not qualify for consolidated regulation because consolidated regulation is required for regulatory exemption in many foreign nations. In those cases, the industrial bank must work with the FDIC to ensure that all foreign transactions can be directly regulated by the FDIC and conform to all U.S. standards and requirements including the Bank Secrecy Act, USA PATRIOT Act, and information system requirements.

Another criticism leveled at the bank centric regulatory model is that it is weak because industrial bank holding companies are not subject to the same minimum capital standards as a traditional bank holding company. We do not agree for a number of reasons.

First, many industrial bank holding companies are subject to consolidated regulation by the SEC or OTS and those regulators have minimum capital requirements for holding companies.

Second, the capital ratio of a large diversified holding company is largely irrelevant to the bank's financial condition. Most large diversified holding companies can provide whatever capital a subsidiary bank may need regardless of the parent's own capital ratios. In many cases the bank's capital is not material to the parent's financial statements. It does not matter whether those holding companies have capital ratios of 10% or 1%; they can still provide whatever capital the bank needs.

Minimum capital requirements for a holding company are appropriate when the bank is the holding company's only significant asset. An insolvent holding company can be a risk to the bank when it is the holding company's primary source of income. It is prudent to prevent a traditional holding company from engaging in risky activities or incurring losses that would cause a capital impairment because the holding company is mostly an extension of the bank and, at a minimum, must not become a burden to the bank or overly reliant on the bank for income.

But that is the only significant reason for a minimum capital requirement for a traditional holding company. In a typical case, a traditional bank holding company's capital apart from the bank is just a small fraction of the bank's capital. A traditional bank holding company is rarely able to provide any substantial financial support to the bank regardless of how much capital the holding company has. In this context, the "source of strength doctrine" employed by the Federal Reserve does not mean the holding company is really a source of any substantial support to the bank. Instead, it means that the holding company will not become a problem for the bank.

In contrast, a large diversified holding company usually holds capital and unencumbered funds many times larger than a bank subsidiary and can provide whatever capital a subsidiary bank may need to expand or to cover loan losses. In other words, it can be a real source of strength to the bank.

Capital ratios in a large diversified holding company are usually determined by factors having nothing to do with the bank. A large manufacturer may be considered financially strong with a lower capital ratio than a bank. It may not need a higher level of capital and reserves because it is not primarily a lending business faced with the risk of loan losses. Accumulating large amounts of capital could impair the ability of some companies to compete with their peers and properly manage their stock in the capital markets. The financial condition of the parent is much less of a risk to the bank in this context because the bank is not the holding company's only source of income.

In instances where the bank's holding company is financially weak or reliant on the bank's income, the bank's regulators can protect the bank by increasing controls on dividends to the parent and asset quality at the bank. This scenario was a major factor in designing the bank centric model from the outset. This is one reason why the bank centric model includes enhanced measures to ensure independent control of the bank. The model has been tested in several cases where the bank's parent developed substantial problems or collapsed altogether. In every case, the bank remained fully insulated from those problems. In the worst case, the collapse of the bank's parent affected the flow of new business to the bank but did not render the bank insolvent. Instead, the bank closed and commenced an orderly liquidation. Its assets were high quality and sold for a significant premium. The bank paid all of its depositors and creditors in full then used the remaining funds to pay a substantial liquidating dividend to the parent.

We think it is appropriate for the FDIC to consider the relative strength of each holding company and prescribe appropriate measures to ensure the bank's solvency and financial strength in orders approving applications and in recommendations in examination reports.

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?*

Any factor potentially affecting the safety and soundness of the bank, public needs and convenience, and the safety of the banking system generally would be relevant. It is appropriate for the FDIC to evaluate the reasons why a particular owner wants to organize or acquire a bank, the likelihood that the bank will operate safely, honestly and fairly, the owner's competence and reputation for honesty and integrity, and the credibility of the bank's business plan. No specific list of factors could encompass all of the relevant factors that might arise in future applications, especially in the diverse group of companies organizing industrial banks.

For example, we believe it would be appropriate for the FDIC to consider whether approval of an application might affect rural areas with limited financial services providers and require, as a condition of approval, that the bank demonstrate that it would not potentially monopolize or limit access to financial services in the areas it would serve. That condition would be justified as a measure designed to ensure that public needs and convenience are served.

Conversely, we think it is appropriate to give preference to banks that serve unmet or underserved needs and convenience in a safe and sound manner. A good example is the industrial bank serving the trucking industry described above.

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 [the] 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?*

The seven statutory factors listed in 12 U.S.C. 1816 and the similar factors list in 12 U.S.C. 1817(j)(7) are in many respects broadly worded and would accommodate all of the considerations described in our prior answers as appropriate for the FDIC to consider and address in an order approving an application. However, we do not believe there is any authorization, and it would be arbitrary and improper, for the FDIC to impose any general restrictions or conditions on all industrial banks or on any particular group of banks solely because the parent company is a financial or commercial company or is not subject to consolidated regulation.

For example, the enhanced requirements for independent control imposed on all industrial banks described in our answer to Question 1 is consistent with the FDIC's responsibility to evaluate the risk presented to the Deposit Insurance Fund in accordance with factor number (5) in the list set forth in 12 U.S.C. 1816. The possibility of broader affiliate relationships warrants requiring stronger independence as a policy applicable to all industrial banks.

The same could not be said for a general prohibition or limitation on branching for all industrial banks or a particular groups defined by ownership. There is nothing inherent in the nature or structure of industrial banks generally that would make branching more risky than for a commercial or community bank. No link could be made to safety and soundness or compliance with applicable laws that would justify limits on branching not applicable to other banks.

On the other hand, legitimate branching issues may arise in a particular application that would warrant some limitation. For example, it would be appropriate for the FDIC to consider whether a particular bank might monopolize or reduce banking services in a particular community. That would be appropriate under the mandate to consider how a bank would serve public needs and convenience.

Each application should be evaluated on its own merits. Approval should depend on whether the applicant is a legitimate and well run company with a sound business plan and a competent management team and the bank, if approved, will serve public needs and convenience in a safe and sound manner. Nothing inherent in being a commercial company, a financial company or a bank holding company limits the ability of an applicant to satisfy all of the foregoing considerations or any of the statutory factors. Accordingly, it would be arbitrary to impose limitations on a bank solely because its parent is not a bank holding company or a financial company.

Consideration of the seven factors in 12 U.S.C. 1816 and the six factors in 12 U.S.C. 1817(j)(7) is mandatory. Conditions in an order approving an application reasonably related to any of those factors (depending on the type of application) would be authorized under the law. But there are limits on the FDIC's discretion. The FDIC cannot impose restrictions or conditions that are not authorized by law, it cannot adopt requirements or conditions that conflict with or effectively repeal a law, and it cannot take any action or impose any conditions, requirements or restrictions that are arbitrary and capricious.

A good example of actions by a federal regulator exceeding its authority occurred when the Board of Governors of the Federal Reserve ("FRB") classified a NOW account as a demand account for purposes of defining the exemption for certain kinds of depository institutions from the Bank Holding Company Act ("BHCA"). Both before and after the enactment of CEBA in 1987, a bank could not be exempt from the BHCA if it offered demand deposits or, prior to CEBA, offered demand deposits and made commercial loans. This was a time when developments in the financial services markets caused a growing number of companies to seek access to a depository charter exempt from the BHCA. The FRB's efforts to constrain the development of these banks included classifying as a demand account any account that in practice functioned like a demand account.

Many banks disputed the FRB's classification of NOW accounts as demand accounts and the issue ended up in court. The case in which the issue was first decided arose during the period when federal law limited the interest federally insured banks could pay on deposits. To combat disintermediation when the inflation rate was higher than the federal deposit interest limits, many bank holding companies acquired or organized non federally insured depository subsidiaries that could pay market rates on deposits. In 1981, a Utah based bank holding company named First Bancorporation ("FB") applied to the FRB for approval to acquire an ILC named Beehive Thrift and Loan ("Beehive"). FB already owned a commercial bank and another industrial bank named Foothill Thrift and Loan ("Foothill"). The Foothill acquisition had been unconditionally approved by the FRB a few years before. After Foothill was acquired by FB but before FB sought to acquire Beehive, Foothill began offering NOW accounts. FB stated in its application to acquire Beehive that it intended to offer NOW accounts through Beehive which would pay rates of interest higher than those permitted for federally insured depository institutions.

The FRB approved FB's acquisition of Beehive on two conditions. First, it prohibited offering NOW accounts if Beehive also made commercial loans. Second, if Beehive did offer NOW accounts, they would have to be treated as demand deposits. That meant the ILC would have to maintain reserves with the FRB and could not pay interest on the account. The order approving the application also extended these provisions to Foothill and its NOW accounts. These conditions were based on a determination by the FRB that NOW accounts were demand deposits.

FB successfully challenged these conditions in federal court. In *First Bancorporation v. Board of Governors of the Federal Reserve System*, 728 P.2d 434 (10th Cir. 1984), the U. S. Court of Appeals for the Tenth Circuit upheld a ruling by the district court that NOW accounts are not demand deposits and invalidated the conditions relating to NOW accounts in the FRB's Beehive order. The court found no merit in the FRB's argument that NOW accounts are demand deposits because they are functionally equivalent. It was undisputed that most checks drawn on NOW accounts are paid on presentment and institutions rarely invoke their right to delay a withdrawal. The court decided that didn't matter. It noted that the statute specifically defined a demand account as one subject to a *legal right* to withdraw on demand. The court cited legislative history from 1966 in which Congress specifically rejected language proposed by the FRB which would have defined a demand account as one payable on demand *in actual practice*. Instead, Congress substituted the standard based on a *legal right to withdraw on demand*. The Chairman of the Senate Banking Committee at that time stated that the difference "clearly excludes industrial loan corporations" (728 F.2d 437 citing 112 Cong. Rec. 12386).

Following that decision, the FRB amended Regulation Y to define a "bank" as any institution holding deposits that "as a matter of practice" are paid on demand. This amendment affected many depository institutions otherwise exempt from the BHCA, including OCC chartered non-bank banks. One of those, Dominion Financial Corporation, challenged this amendment. Other BHCA exempt institutions challenged it as well and at one time cases dealing with the same issue were pending in the Fourth, Sixth and Tenth Circuits. Those cases were consolidated in the Tenth Circuit, which issued a decision invalidating the FRB's amendment to Regulation Y based on its decision in the *First Bancorp* case. The FRB appealed to the US Supreme Court, which affirmed the Court of Appeals in *Board of Governors of the Federal Reserve System v. Dimension Financial Corporation*, 474 US 361, 88L Ed 2d 691, 106 S Ct 681 (1986). The key to the Court's decision was its finding that "[t]he Board's definition of 'demand deposit' . . . is not an accurate or reasonable interpretation of § 2(c) [of the BHCA]." *Id* *at 474 US 368, 88 L Ed 2d 691*. The Court then declared invalid the amendments to Reg. Y classifying NOW accounts as demand deposits.[5]

Any attempt to impose special restrictions or conditions on industrial banks generally, or any group of industrial banks such as those owned by a commercial parent or a parent not subject to consolidated regulation, would be invalid for the same reasons as the FRB's classification of NOW accounts if the restriction or condition is not authorized by law.

No law authorizes the FDIC to impose restrictions on classes of industrial bank owners or on activities and authorities of their subsidiary banks if the restrictions are not based on considerations relating to safety and soundness or public needs and convenience. On the contrary, Congress expressly exempted *all* owners of qualifying industrial banks from the restrictions on activities in the BHCA and from consolidated regulation. Congress could have imposed other conditions on those bank owners, or authorized the FDIC to do so, but did not. Thus, the FDIC does not have either explicit or implicit authority to impose ownership restrictions on banks due solely to the status of the bank's parent company, activities of its affiliates, or the lack of consolidated regulation of the bank's parent company and affiliates.

The same issue would arise with regard to restrictions on branching. Congress enacted Riegle-Neal I and Riegle-Neal II in the 1990s to govern branching by all federally insured banks. Nothing in those laws permits a regulator to impose restrictions on any class of bank that are different than those imposed on other banks. Indeed, the general counsels of the FDIC, the OCC and the FRB recently issued a joint letter concluding that state laws blocking industrial banks from branching into a state violate the provisions of Riegle-Neal permitting de novo branching into a state only if the state enacts a law expressly permitting de novo branching that applies equally to all banks. Thus, a regulation imposing branching restrictions on all industrial banks or those owned by certain classes of parent companies would be unauthorized and in conflict with the law.

Across the board restrictions on industrial banks not reasonably related to one of the seven factors but based instead on whether the bank's owner is a commercial company or has consolidated regulation would also be arbitrary and capricious. The Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701 to 706 mandates that reviewing courts set aside agency findings that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). If an administrative action is challenged, agencies decisions are granted deference if there is a rational basis for the action taken but a court will "review the evidence anew and determine whether [for itself if] the administrative action was arbitrary and capricious." *First Nat'l Bank of Fayetteville v. Smith*, 508 F.2d 1371, 1374 (8th Cir.1974), *cert. denied*, 421 U.S. 930, 95

[5] In CEBA, the FRB finally persuaded Congress to prohibit any kind of transaction account for certain depository institutions exempt from the BHCA. However, the original language prohibiting only a demand deposit was retained for industrial banks.

S.Ct. 1655, 44 L.Ed.2d 86 (1975); *see, e.g.*, *Hymel v. FDIC*, 925 F.2d 881, 883 (5th Cir.1991).

Here, there is simply no evidence supporting a conclusion that a bank owned by a commercial company or an entity not subject to consolidated regulation is any more of a risk to the Deposit Insurance Fund than other insured banks. Indeed, for the past twenty years, the FDIC has expressly and consistently said there is no need to impose restrictions on industrial bank holding companies generally or because they are a commercial company or lack a consolidated regulator. That means the FDIC would potentially be the strongest witness against itself if it suddenly changed its position without any change in the underlying record and that action was challenged in court.

Apart from the FDIC's own position on this for the past twenty years, the record of banks owned by commercial companies and entities not subject to consolidated regulation is extensive and well established and no evidence, real or theoretical, has developed to support any contention that they pose any unique or unusual risk to the bank, the banking system, the payments system or public needs and convenience. On the contrary, industrial banks owned by commercial companies and companies not subject to consolidated regulation, and all other industrial banks for that matter, have proven to be generally stronger, safer and less likely to fail than traditional banks controlled by a bank holding company.

Additionally, many traditional banks are not owned by bank holding companies and are not subject to consolidated regulation. Those banks have not proven to be less strong or safe than banks generally and are not subject to any special conditions or restrictions. It would clearly be arbitrary to impose restrictions and conditions on industrial banks solely because they lack consolidated regulation but not other banks in the same category.

Another example of the capricious nature of general restrictions on industrial banks or any group of banks is that some industrial bank parent companies would be classified differently (financial, commercial and other) from time to time. One industrial bank is owned by a parent that has been acquired and sold on more than one occasion. The bank itself and its parent were otherwise unaffected by these changes in ownership. Their business did not change and the bank's financial strength and profitability always remained strong. At one time the bank's parent was owned by a corporation with many different subsidiaries engaged in commercial and financial activities. In a recent reorganization, the bank's parent was divested and is now publicly traded. Some of its largest shareholders are financial management companies that primarily invest funds for pension plans and other entities holding large cash positions. For safety, the financial managers maintain diverse investments in many kinds of companies, some of which are technically controlling interests. One of those managers, which holds controlling but passive interests in other companies, recently acquired technical control (under Utah's lower definition of control) of the bank's parent company. That control is passive. The investor merely increased its position from slightly below 5% to slightly above 5% of the parent company's stock because it had turned out to be a good investment. (The investor understood it needed to register with the state as a holding company and promptly did so). Depending on the investments held by that investor in other companies, crossing the control threshold could cause the bank's parent company to be reclassified as a commercial company. Another variation on this theme is that such an investor might qualify as a financial company when it invests in the bank's parent company but later make new investments that cause it to be reclassified as a commercial company. Throughout all of these changes, the bank's parent, which has not otherwise changed, could have been classified commercial, then financial (or not controlled), then possibly commercial again. Most importantly, the changes described above did not affect the bank in any way. Nevertheless, if restrictions are placed on banks owned by a commercial company, a change in the status of a bank's owner could significantly impact the bank even though nothing changed that would expose the bank to greater risk. There simply is no valid link between ownership status and risk to the bank.

A publicly traded company would not have the option to prohibit an investor from purchasing its shares if that would cause the bank's parent company to become classified as a commercial company. The parent company would only know after the fact if an equity fund or mutual fund with controlling positions in commercial companies had purchased enough of its shares to constitute technical control. That is less of an issue for a large company because the amount needed to purchase a controlling interest is more than what most investors would consider. But it would be an issue for a smaller company and would effectively require it to stop trading publicly, so it could limit who can invest, or find another way to offer its financial services than through a bank.

Imposing restrictions on banks owned by a commercial parent would mean that a subsidiary bank of a publicly traded company might have to periodically make major changes in its operations as a result of share purchases in the open market. As a practical matter, that would severely constrain the development of the affected banks. Most banks would not develop beyond what would be permitted under the restraints on commercially owned banks, which would limit their value and possibly make them more prone to fail.

Those consequences would clearly be arbitrary and capricious and very material to the companies affected. At a minimum, it would be a strong incentive for the parent company to consider other ways to offer its financial services even if they would be less efficient and profitable than if provided by a bank.

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?*

For the reasons stated in the prior answer, we believe imposing requirements or restrictions such as those listed in the questions above on all industrial banks or any of their parent companies would be unauthorized, arbitrary and capricious if based solely on the nature of the bank's owner or the bank charter. No restriction or requirement would be valid without a specific finding based on the record in each individual application linked to one of the statutory factors.

The key consideration is the distinction between conditions based on safety and soundness and the other statutory factors in the FDI Act and conditions involving policies within the exclusive purview of Congress. When it enacted CEBA in 1987, Congress expressly exempted industrial bank owners from the activities restrictions in the Bank Holding Company Act and consolidated regulation by the Federal Reserve (but not the anti-tying provisions in the BHCA). It did not grant to the FDIC any authority to impose restrictions on industrial banks or the parents and affiliates similar to those imposed on bank holding companies if they are not linked to the statutory factors, the safety and soundness of the bank, or serving public needs and convenience. The same limits on the FDIC's authority apply to requirements unrelated to the statutory factors that Congress has not adopted in law. It would be arbitrary and capricious to impose growth restrictions on industrial banks absent a finding that it would be unsafe for the bank to grow at a higher rate. It would be improper to ban or restrict branching beyond what is set forth in the Riegle-Neal Banking and Branching Efficiency Act of 1994 without finding that it would be unsafe and unsound for the bank to establish branches or that it might cause a monopoly or reduction of financial services and not serve public needs and convenience. Imposing a higher capital requirement than is required for other banks would be arbitrary and capricious if not linked to increased risks of a capital impairment in a particular bank application.

Historically, restrictions on specific classes of bank charters have usually caused more harm than benefit. Indeed, in many instances imposing restrictions is a slow way to kill a charter.

The organization of a bank is ultimately a business decision made for business reasons. A company needs a reasonable degree of certainty to properly plan a business. All else being equal, a company will be reluctant to build a bank or financial services business around a charter that may be subject to unforeseen or unannounced changes.

Some banks are designed to perform only limited supporting functions and will do fine as long as they can do their job. Good examples are Escrow Bank USA and the bank proposed by Wal-Mart. But for any bank organized to conduct a retail financial services business, flexibility is another key consideration. A bank owner will be likely to commit the maximum resources to a bank only if the bank can act on new opportunities or respond to new competition. The ability to compete and act on new opportunities is one of the primary reasons why many businesses organize a bank.

The success of any retail financial services oriented bank depends entirely on its ability to compete in the market and to do that it must be able to respond to market changes. That is the only way it can maintain the viability of its products and services and be in a position to act on opportunities that arise from time to time. Constraints on growth, products, branching and other features of the business run directly counter to these needs. Restrictions can cause a bank to atrophy and not achieve its maximum success or fail.

Growth caps imposed on the group of banks called “non-bank banks” in 1987 essentially killed the industry. Operational restraints on savings and loans prior to 1980 prevented them from adapting their business to changing market conditions when inflation caused a hemorrhage of operating losses in the 1970s and ultimately resulted in the closure of nearly 80% of that industry. It can be particularly seen today in the disadvantage state chartered banks have in contrast to national banks and federal savings banks in preempting state laws. In the current financial services industry, asset growth is largely concentrated in the federal charters because they are the most flexible and have the most powers.

Restrictions that currently apply to state chartered banks have put the dual banking system in jeopardy. The total percentage of assets held in state chartered banks is falling because those charters lack the preemptive powers of national and federal savings banks. Within the next few years, state banks could become too small in some states to support state regulatory agencies. Dual banking has been critically important to the U.S. banking system. While many new state chartered community banks have been organized in the past few years, the only state bank charter showing significant asset growth is industrial banks. Imposing restrictions on that charter for reasons not linked to safety and soundness, compliance with law, sound management and other appropriate factors, would significantly damage the charter and the current industry. If all industrial banks closed, and current trends in bank assets flowing to national and federal savings banks continue, some predictions are that state banks could decline to the point where they would be largely irrelevant to the banking system in the next few years. The demise of state chartered banking would eliminate a substantial degree of diversity from the banking system. That diversity has resulted in much of the innovation in the U.S. banking industry over the years and would be sorely missed in the future.

Charter restrictions also inhibit growth and development, which are directly linked to flexibility. A credit card bank may be able to grow and prosper to a degree but it is at a constant competitive disadvantage compared to a bank that can offer cards with more features and leverage customer relationships with additional products and services.

Safety and soundness and serving public needs and convenience is the only valid reason for the FDIC to impose operational, product and branching restrictions on any bank. Imposing growth, branching, and other restrictions on industrial banks would substantially harm the charter generally and all affected operating institutions. It would cause many businesses to pursue other options when they might be able to achieve their legitimate and well planned goals best through an industrial bank. The industrial banks are legitimate, sound, thriving businesses. No systemic problems or deficiencies have developed in the industrial bank industry or are likely to occur. There is simply no objective evidence that would justify inflicting such harm on a group of these banks or the entire industrial bank industry.

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?*

As stated above, we believe any such restriction if applied across the board to all ILCs owned by a financial or a commercial company would be arbitrary, unauthorized and illegal.

There is no basis for any assertion that ILCs pose any unique or unusual safety and soundness risk to the Deposit Insurance Fund for any reason or that there is any unique or unusual safety and soundness risk if a bank is owned by a financial or commercial parent. There is no record, evidence or credible theory supporting any such claim so there is no issue to be addressed. By any objective measure, the industrial bank industry has proven to be at least as safe and sound as any other group of banks and they have proven to be safer than traditional banks owned by bank holding companies. The controversy over industrial banks is political in nature and attacks on the industry's twenty year record of safe and sound operation have no basis in reality.

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 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?*

As stated in preceding answers, Sections 23A and 23B and the anti-tying provisions of the Bank Holding Company Act effectively control potential conflicts of interest between a bank and its affiliates. Such conflicts are certainly not unique or even necessarily more prevalent in a bank owned by a commercial company. A traditional bank holding company may have affiliates that sell insurance or securities and a conflict would arise if the bank finances the purchase of any such product from its affiliate. All loans to buy products and services from an affiliate are covered transactions subject to Sections 23A and 23B and anti-tying laws. Any transaction involving a conflict of interest that might not be subject to these laws is inherently unsafe or suspect and can be regulated under general standards of safety and soundness.

As described above, most commercially owned industrial banks do not finance transactions with affiliates. They operate a core financial services business comparable to any other bank but just happen to have affiliates engaged in commercial activities that are otherwise unconnected to the bank, or they offer traditional bank products and services to customers of an affiliate. Those banks do not engage in transactions with or that benefit their affiliates so there is no conflict of interest or inherent risk to address with any general restriction on ownership. Banks that do finance transactions with affiliates are restricted by Sections 23A, 23B and the anti-tying laws. They only originate loans that are fully collateralized by a cash deposit in the bank or U.S. Government securities, or sold without recourse. Their loans are all priced at market, and the bank offers no preferential terms or other incentives to engage in transactions with affiliates.

The industry's record over the past twenty years confirms the effectiveness of these controls. Several commercial companies own industrial banks and only isolated and inadvertent violations of the affiliate transaction laws have been noted in any examination.

Of course, many commercial businesses use a bank to promote sales at retail stores but they usually utilize an "affinity" or "co-brand" relationship with an independent bank. For example, Home Depot offers in store credit but it is not the lender. Citibank is the actual lender even though Home Depot's name is on the ads, cards, etc. Because Citibank is not an affiliate of Home Depot, it is not subject to Sections 23A and 23B or the anti-tying laws and it can finance in store purchases and offer discounts to use the credit for that purpose without restriction. In this type of arrangement, the bank either pays a fee to the retailer for all credit used at the store or sells the receivables to the retailer for collection. We call this to your attention because these arrangements are common and most people will readily recall shopping at a store that offers financing discounts and other credit related incentives to buy things at that store. It is important not to confuse those programs with any offered through a bank owned by the store.

Covered transactions and compliance with Sections 23A and 23B and the anti-tying laws are carefully reviewed in all de novo bank applications and notices of change of control. Business plans that do not ensure compliance can be disapproved for that reason. This has proven adequate to control affiliate transactions and avoid conflicts of interest in the application process.

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?*

Except as noted below, commercially owned banks generally have no inherent competitive advantage over other banks. They compete with other banks on equal terms for business with unaffiliated parties.

The primary advantages that some commercially owned banks have are the greater ability of many commercial parents to provide capital, secure sources of business, and savings on marketing costs.

As mentioned previously, it is typically easy for a commercial parent company to provide capital to a subsidiary bank. In contrast, raising capital can be very difficult for a traditional bank and bank holding company. If a new opportunity arises that would require significant growth, obtaining added capital will typically be much easier for a commercially owned bank than a traditional bank. More importantly from a regulatory perspective, if a bank suffered potentially lethal loan losses, many commercial parents would be able to infuse new capital to save the bank while a traditional bank would be much more likely to fail.

The opportunity to leverage existing customer relationships is also a distinct marketing advantage when competing with an independent bank. Some commercially owned industrial banks are able to offer greater convenience to customers in addition to leveraging the existing customer relationship when offering financial services. The bank described above that primarily serves truckers is a good example. It is not really competing with other banks because they usually do not serve truckers. Because it is affiliated with the truck plazas where truckers live when they are on the road, this bank has the ability to deliver financial services that otherwise would not be available to most truckers, especially independent owner operators, and that is an advantage when offering financial services to those customers.

Some commercially owned banks have a higher degree of expertise and knowledge about a particular industry or group of customers served by the bank's affiliates and that provides an advantage in designing products and services to serve the specific needs of that industry or those customers. In many cases the bank's parent company developed a financial services business to begin with and subsequently organizes the bank to conduct that business in a more cost effective manner. This is not an unfair competitive advantage over a bank that wants to compete for that business, as is often insinuated by industrial bank critics. For example, companies within one retailer corporate group invented in store credit and offered revolving in store credit before any bank offered competitive credit. That retailer has an industrial bank subsidiary that offers a credit card designed specifically to meet the needs of certain commercial customers that shop at affiliated stores including several disaster relief groups that utilize accounts at those stores to help disaster victims purchase new clothing and incidentals. Those disaster relief agencies did not borrow from other banks to provide this assistance in the past. Their accounts, along with the accounts of many other commercial customers, were always at those stores. The retailer only figured out how to manage those accounts more efficiently through the bank. It is certainly not the case that the retailer is using any unfair competitive advantage to steal this business. *It was the retailer's business to begin with*. The only advantage the retailer has used to build this business is convenience to the customer. Fees and charges are competitive in the market and are not subsidized. Because the accounts are used to make purchases at an affiliate, the parent maintains a cash deposit in the bank securing all of the outstanding account balances owed to the bank. When facts such as these are known, there is no reasonable way to characterize this program as unsafe or a threat to the banking industry generally or the market, or to criticize it any other way.

Commercial companies that want to use financing programs to facilitate sales by the company or its affiliates have three feasible choices.

One is to finance the sales directly not using a bank. This is how most commercial companies operate. Some of these captive finance companies are as large as most banks. These companies also rank among the most competent and successful providers of financial services. The expertise and sophistication of these operations equal or exceed most banks. Many of these companies will never organize a subsidiary bank to take over a financial services business used to finance transactions with affiliates because of the restrictions in Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act.

Another option is to partner with an independent bank such as the affinity or co-brand relationship between Home Depot and Citibank. The retailer handles all of the marketing and the bank provides the credit. In some instances, these programs are less costly for the retailer than directly offering in house finance. Often the retailer buys the receivables from the bank and handles all collections. As mentioned above, these programs are not subject to Sections 23A and 23B or anti-tying laws and can include many features designed to encourage use of that credit to make purchases from the commercial company.

The third option is to organize a bank controlled by the retailer to finance purchases. This is the least common arrangement because of the constraints imposed by Sections 23A and 23B and the anti-tying laws. This kind of program is most often utilized by a retailer that only wants to offer in house credit and it is prepared to fully finance on its own by buying the bank originated receivables without recourse or maintaining a pledged cash deposit in the bank equal to all of the bank's receivables. The advantage is the ability to standardize credit terms in multiple states, exemption from many licensing laws, and the ability to offer a general purpose credit card. It can also enable the merchant to capture a portion of the interchange fee, which is a major consideration to some commercial companies. For example, one retailer with a subsidiary bank that issues credit cards for in store purchases operates with a gross profit margin of about 6%. Interchange fees when a customer uses a credit card issued by an independent bank may be as high as 3%, *half* of the store's gross profit. Offering in house credit captures a portion of that interchange fee and is thus a major competitive issue for the company. But it can only use its own bank for that purpose if the company assumes all risks and does not offer any incentives to use the in house credit other than the simple convenience of having it available in the store.

We do not believe the competitive advantages described above warrant any new laws, regulations or regulatory actions. The competitive advantage offered by a large financial services organization such as the insurance company described above or by many financial holding companies is generally much stronger than any advantages enjoyed by commercial companies offering financial products and services. In many cases, customers of financial companies demand that they offer a broad range of products and services such as securities, loans and insurance from one source with appropriate volume discounts. The link between two financial products, such as insurance and credit cards or securities underwriting and commercial debt financing, is usually much stronger than the link between socks and stocks or loans.

The fairness of these links should also be considered. The mere fact that a commercial company may have a competitive advantage does not mean it is unfair and should be restricted or eliminated. The modern financial services market is built to a large degree on such links. Most credit cards offer a host of rewards to incentivize cardholders to use the cards for every purchase. These links exist because they benefit customers and are supported by high market demand.

Many attacks on industrial banks also have anticompetitive goals that do not warrant regulatory support. Uncompetitive businesses often attempt to use the law as protection from competition. Laws of that sort usually harm consumers and the markets. For that reason, laws suppressing competition are generally undesirable.

The demand for bundled services is a major and common source of business development throughout the economy. Banks are not immune from that effect. "Hurdle rates" are commonly employed by banks to price a new loan when the bank already obtains income from the same customer in other areas. In recognition of the demand for these benefits, discounts for customers that utilize multiple bank services are expressly exempt from the anti-tying provisions of the Bank Holding Company Act.

Many traditional banks cannot expand these benefits beyond the bank because of the activities restrictions applicable to affiliates. Even many financial holding companies complain that it is unfair to compete against companies that can also engage in commercial activities. It is worth noting that most proponents of separating banking and commerce are the banks that are most protected by the activities restrictions in the Bank Holding Company Act and the Federal Reserve, which administers the BHCA. For those industry opponents, the separation of banking and commerce really means the separation of banking from competition.

In response to these complaints, industrial banks do not oppose repeal of the activities restrictions in the Bank Holding Company Act to provide competitive equality where there is actual competition between traditional and industrial banks.

In some instances, the unfair competition argument has no merit because there is no substantial competition between many industrial and traditional banks. The bank affiliated with truck stops is a good example.

We are aware of no instance where a commercial company has an *unfair* competitive advantage over traditional banks. The biggest concerns discussed in Washington relate to an application by a building products company to acquire an existing bank that specializes in financing unaffiliated home improvement products. The fear is that the subsidiary bank will coerce customers to shop at the affiliate and steal home improvement business from traditional banks. However, that cannot happen under current laws. The anti-tying laws expressly prohibit a bank from requiring a customer to obtain a product or service from an affiliate as a condition of obtaining a loan, or discounting any rate or fee for a bank product on the condition that the customer purchase other products or services from an affiliate. Additionally, if a bank made loans to purchase building materials from its affiliate, the loans would be covered transactions under Section 23A and the affiliate would have to collateralize the loans or purchase them without recourse from the bank.

The opportunity for bundling applies only to the affiliate unless all of the tied products are bank products. A non bank affiliate is not prohibited from offering discounts or other incentives for doing business with its affiliates, including the bank. Holding companies of every kind, including bank holding companies, are free to spend their marketing money however they want, including providing rebates or other perks to customers of the corporate group. Those marketing incentives have never been considered unfair and do not violate any law. Accordingly, we do not believe that any restrictions on commercially owned industrial banks are warranted to protect competitive fairness and equality.

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 extend can or should the FDIC consider these benefits if they exist?*

We have already described many instances of such benefits. The bank serving truckers is one of the best examples. It is the only means of access for its customers to the kinds of financial services most people take for granted.

Another good example is Community Commerce Bank in Los Angeles, California. Community Commerce Bank is owned by The East Los Angeles Community Union (TELACU). TELACU is a non profit organization dedicated to community development primarily in lower income neighborhoods of East Los Angeles. TELACU operates a number of for profit businesses to raise money for community development programs. Many of those for profit businesses engage in non banking activities that would not be permitted under the Bank Holding Company Act. Profits from TELACU's for profit subsidiaries subsidize a number of other non profit programs. For example, TELACU owns a development corporation that builds subsidized senior and affordable housing. It has also established an intercity energy systems program in coordination with The Gas Company and Edison International to provide a variety of energy conservation products and services as free public service to 10,000 qualifying low income households annually. TELACU has an education foundation that provides $1.5 million in scholarships to 600 college students annually, educational programs to its 600 scholars and to 2500 middle and high school students, and total scholarship programmatic assistance to low income students of approximately $3.5 million annually. The public, particularly the minority and low income communities of East Los Angeles, benefit greatly from the affiliation of the bank with TELACU and its other for profit non financial affiliates. During the decades of affiliation, there has been no regulatory concern about the bank's safety and soundness nor have the regulators identified any risk to the bank from its affiliation with TELACU or its non financial affiliates.

There is no good reason to limit or entirely cut off the development of banks to provide mainstream financial services to groups such as these. In the case of the banks described above, the commercial affiliation is the key to providing those services. These benefits should be acknowledged and appropriately weighed when considering whether to allow banks to be owned by any competent and capable parent.

The FDIC already has an excellent tool to evaluate the contribution made by banks associated with commercial concerns. Industrial banks are subject to and embrace the Community Reinvestment Act. A simple review of the CRA ratings of the existing banks will confirm an excellent track record of providing greater access to banking services.

Public needs and convenience is one of the statutory factors the FDIC must consider when evaluating an insurance application or notice of change of control. We cannot think of any consideration that could be more relevant or pertinent to that assessment than the kinds of banking services described above.

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?*

The most useful insight in understanding industrial banks is to simply see the whole industry instead of the political controversy surrounding one or two individual applications by entities that are controversial for their own particular reasons. Industrial banks are an established thriving industry consisting of a diverse group of banks that are solid, honest, and successful and supported by strong and growing market demand. The success of the industry is a classic example of the kind of experiment made possible by dual banking. It has been conducted on a manageable scale at the state level under careful regulatory oversight. We believe the unified regulatory model that has emerged from this experiment will safely accommodate all existing banks and the broad array of new banks that will develop naturally as the financial services markets evolve in the next century.

This is an almost unique feature of the U.S. economy. Most other countries are dominated by a small number of large banks or a small number of large corporate groups that include captive banks. Banks in those countries are often more a utility for the nation's economy or a large corporate conglomerate. In contrast, the U.S. financial services markets have expanded throughout the economy and developed the broadest array of financial products and services ever seen. The biggest differences are diversity and innovation. The U.S. is leading the world in developing new financial products and services. Devising the bank centric regulatory model to work within this diversified market is a major accomplishment that will help preserve our position as the leader in the world's financial markets in the future.

By any fair measure, the current industrial banks should be facilitated and encouraged. They are generally stronger, better capitalized and better supported than traditional banks. Their boards and management meet the highest standards in the industry. When the success of any bank is dependent on its ability to develop a long term source of good profitable loans, many industrial banks have no marketing cost or challenge. They take over established financial services businesses or are provided with a steady source of business through their affiliates and are profitable and highly developed from inception. In contrast, most traditional banks must develop and sustain sources of business independently without any support from affiliates.

It simply defies reason to consider imposing unique and very damaging restrictions and prohibitions on the industry, or any particular group of banks in the industry, when *there is no identifiable problem or risk that warrants any such action*. Those restrictions would be gratuitous and therefore arbitrary. The efficiency and development potential of the financial services markets generally would be impacted. It would truly turn the regulatory system on its head.

We also want to stress again the importance of ensuring that the regulatory system is compatible with the financial services markets. The role of a regulator cannot be fulfilled if requirements and prohibitions are imposed that conflict with the demands of consumers of financial services and the opportunities driving the markets.

That is the primary problem with the Bank Holding Company Act. It is outdated and incompatible with the financial services market that has developed over the past thirty years. Businesses of every kind now offer financial services. The financial services market has played a major role in the development of the U.S. economy over the past several years. Supporting these developments serves public needs and convenience in the most basic way and that is what the FDIC must do to fulfill its legal and regulatory responsibilities.

The growth of the industrial banks is a direct result of developments in the financial services markets. A large and growing number of businesses offering financial services realize they can do that most efficiently and cost effectively through a bank. Those companies need access to a depository charter for that reason. These are legitimate and highly competent businesses. Many invented the financial services they provide and there is no credible reason for denying them access to a depository charter solely because they have other subsidiaries or divisions that engage in completely legitimate and safe and sound commercial activities. *The only real issue in this whole debate is whether these businesses will be able to operate in the most efficient and cost effective manner possible.*

The FDIC should be commended for identifying these market trends early on and leading the way to develop a regulatory model that safely and effectively serves the needs of the modern financial services market. The worst thing the FDIC could do at this point is to reverse this course by imposing arbitrary, counterproductive and anti competitive restrictions on banks that have become the strongest and safest ever insured by the FDIC. The current laws and regulations have worked. The unified regulatory model has worked. The industrial banks are working very well. The system is not broken and doesn't need to be fixed.

The controversy over industrial banks is political. Industrial banks were attacked first because they prove that there is no need or justification for the restrictions on affiliate activities in the Bank Holding Company Act. The issue has become inflamed by one particular application that has become a rallying point for the many critics of that parent organization and as an opportunity for other institutions to pursue anti competitive agendas. The issue has developed a perfect storm of the kind that often happens inside the Beltway but bears no connection to reality. We believe these political factors should have no bearing on the FDIC's policies governing industrial banks.

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?*

Clearly, the FDIC could not impose restrictions on the owners of industrial banks that are not authorized by law, especially if they would effectively repeal the exemption for industrial bank owners in the Bank Holding Company Act.

We believe the FDIC can, on a case-by-case basis, place restrictions on owners and affiliates of industrial banks that will help ensure the safety and soundness of the bank. That can be done through conditions on approval of an application and examination recommendations enforceable through a variety of prompt corrective actions already at the disposal of the FDIC. We also believe the FDIC can place restrictions on owners and affiliates and the bank that will help ensure that the bank and competing banks serve the public needs and convenience.

In closing, we appreciate the opportunity to submit these comments and we believe the FDIC and others will find them informative. The UAFS and CAIB member banks have enjoyed working with the FDIC over the past several years to develop an advanced and effective regulatory system to serve the needs of the banking industry in this century. We look forward to continuing this cooperative relationship in the future.

Respectfully Submitted,

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UAFS MEMBER BANKS

Advanta Bank Corporation
Allegiance Direct Bank
American Express Centurion Bank
American Pioneer Bank (application pending)
BMW Bank of North America
CapitalSource Bank (application pending)
Capmark Bank

CIT Bank
Celtic Bank
Comdata Bank (application pending)
Daimler Chrysler Bank (application pending)
Enerbank USA
Escrow Bank USA
Exante Bank
First Electronic Bank
Franklin Templeton Bank & Trust, F.S.B.
GE Capital Financial
Globility Bank (application pending)
GMAC Automotive Bank
Goldman Sachs Bank USA
LCA Bank Corporation
Lehman Brothers Commercial Bank
Magnet Bank
Marlin Business Bank (application pending)
Medallion Bank
Merrick Bank Corporation
Morgan Stanley Bank
The Pitney Bowes Bank
Republic Bank
Sallie Mae Bank
Target Bank
Transportation Alliance Bank
Union Financial Services (application pending)
Universal Financial Corp.
Volkswagen Bank USA
WebBank
World Financial Capital Bank
Wright Express Financial Services Corporation

CAIB MEMBER BANKS

Centennial Bank
Circle Bank
Community Commerce Bank
First Security Thrift Company
Fremont Investment & Loan
Rancho Santa Fe Thrift & Loan
Tustin Community Bank

NEVADA BANKS
(Members of UAFS)

EagleMark Savings Bank
Toyota Financial Savings Bank
Fifth Street Bank (application pending)