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October 2, 2006

**VIA ELECTRONIC DELIVERY**

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Comments

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

Dear Mr. Feldman:

The Federal Deposit Insurance Corporation's ("FDIC") request for comment on issues related to industrial loan companies ("ILCs") raises a series of questions about the regulatory oversight of ILCs. These companies are insured by the FDIC, but they are not considered to be banks under the Bank Holding Company Act. Some ILCs are owned by bank holding companies or savings association holding companies and, therefore, their owners are already subject to the traditional holding company supervision that applies to other types of deposit-taking institutions insured by the FDIC. Some ILCs are owned by companies that also own securities broker-dealers. These companies may be subject to consolidated supervision by the Securities and Exchange Commission that is designed, at least in part, to meet internationally recognized standards for holding company supervision. Some ILCs are owned by a family of financial services companies that are not subject to consolidated holding company supervision, even though the bulk of their activities may be permissible for a financial services holding company under the Banking Holding Company Act. Still other ILCs are owned by a family of commercial companies that are not subject to any form of consolidated supervision and are not subject to the activity limitations that are imposed on bank and new savings association holding companies.

The FDIC's request for comment arises in the context of controversy over a recent application by Wal-Mart to establish an ILC in Utah. While other commercial companies have established or acquired ILCs in the past, including General Electric, General Motors, Harley Davidson and Target, either because of the growing number and aggregate size of ILCs, or because of the perceived potential competition for traditional banking institutions, the Wal-Mart application has generated an intense interest.

For the record, I have ILC clients who have an interest in how this issue is resolved. At the same time, I have bank clients who may view the issue the other way. In addition, I had over 26 years experience with the Federal Reserve System during which I had the opportunity to work on the ILC exception to the definition of bank that was included in the Bank Holding Company Act by the Competitive Equality Banking Act of 1987. I also had a close-up view of the results of a number of misadventures in the financial system, including the failure of Continental Illinois, the troubles with the Farm Credit System in the mid-1980s, the Ohio thrift crisis, the Maryland thrift crisis, the restructuring of the Federal Home Loan Bank System and the FSLIC due to widespread failures of thrifts in the 1980s and waves of bank failures from the mid-1980s through the early 1990s.

**Concerns About ILCs**

In order to put the current controversy in perspective, it is useful to revisit some of the arguments that have been raised about the separation of banking and commerce in the past, and how these arguments may apply to ILCs as they exist today. In doing so, it is also useful to remember that the current applications that have been affected by this controversy are not asking for any changes in existing law; rather, they are being made on the basis of federal law as it has existed in the Bank Holding Company Act since 1987.

Some have argued that ILCs that are affiliated with commercial companies exist in a regulatory loophole; present unique risks to the financial system, including the deposit insurance fund; can serve as a conduit for transferring the subsidy of the federal safety net that applies to banks, to commercial affiliates; and compete unfairly with banking institutions whose parent companies are subject to comprehensive federal supervisory schemes. I believe that these concerns are unwarranted and ignore existing limitations on ILCs. Further, any perceived weakness in these limitations could be readily addressed by the FDIC by means of conditions for obtaining federal deposit insurance or for acquiring an insured ILC, or, if deemed necessary, by changes to the regulatory tools available to the FDIC for ILCs that are targeted at the specific weakness or weaknesses.

**Risks to the Financial System**

The perception that ILCs affiliated with commercial companies pose undue risk to the financial system is based on the concern that the management of the ILC will disregard the interests of the ILC in favor of the interests of its affiliates. This concern, in turn, rests on the assumption that commercial holding companies pose a greater risk of failure than traditionally regulated financial services holding companies and that the commercial affiliates cannot be separated from the ILC by adequate firewalls.

First, in the case of most ILCs that are owned by commercial companies, those companies are in a position to serve as a source of strength to the ILC. Indeed, many commercial affiliates of ILCs are in a better position to serve as a source of strength to affiliated ILCs than the owners of many banks and savings associations. Further, the source of strength issue can be addressed, and typically has been addressed in practice, by the owner of the ILC entering into a capital assurance and liquidity maintenance agreement under which the owner commits to keep the ILC well capitalized and to serve as a source of liquidity to the ILC. To the extent that there are concerns about the owner's ability to meet its commitments under these agreements, a commercial company forming or acquiring a new ILC could be required to have investment grade debt ratings and to have an aggregate ratio of non-ILC assets to the assets represented by the ILC of, say, three to one, or greater, to assure that the commercial company has sufficient resources to support the ILC. The combination of an investment grade debt rating and a size ratio would be an effective substitute for a holding company capital requirement and would rely on existing market mechanisms, rather than requiring the FDIC to determine appropriate capital levels for commercial companies.

In addition, sections 23A and 23B of the Federal Reserve Act, as applied to the ILC through the Federal Deposit Insurance Act, limit the ability of an ILC to incur the credit risk of its affiliates. Section 23A stems from the Banking Act of 1933, and represents over 70 years of experience with limiting the risk to insured banking institutions from transactions with their affiliates. Nevertheless, some may argue that due to the rapidity or complexity of modern banking transactions, sections 23A and 23B are not a sufficient firewall between a banking institution and its commercial affiliates. For example, derivative transactions are not subject to the quantitative limits and collateral requirements of section 23A. Intra-day overdrafts in deposit accounts of affiliates held at banking institutions also are exempt from the quantitative limits and collateral requirements, but overdrafts during the day could present a close of business exposure that would exceed the limitations of section 23A. However, ILCs of any size lose their exemption from the definition of bank in the Bank Holding Company Act if they hold demand deposits for their corporate affiliates, so the overdraft issue simply does not apply to ILCs. Further, if deemed necessary, it would be a simple matter to subject derivative transactions between ILCs and their affiliates to the quantitative limits and collateral requirements of section 23A on a mark-to-market basis in order to fill any perceived gap in the firewalls that might exist with respect to derivative transactions.

Even with the stringent limits on transactions with affiliates established by section 23A, it is possible that an event at a commercial affiliate of an ILC could so damage public confidence in the entire corporate family that both the parent company and the ILC would experience funding problems. Although this same issue could arise in a traditionally regulated bank holding company, some may argue that the regulatory structure reduces the likelihood of such an event. First, because ILCs of any size do not take corporate demand deposits, the likelihood of such a funding problem at an ILC is less than at a commercial bank. Second, there are a wide variety of tools to manage liquidity at both commercial companies and banking institutions. ILCs affiliated with commercial companies could be required to maintain robust liquidity management programs, including, for example, limiting reliance on short-term funding from third parties and maintaining back-up lines of credit. Further, credit quality and asset ratio requirements for the corporate family would help to ensure that the affiliates would continue to be a source of liquidity to the ILC, even in difficult times.

In addition, from a risk standpoint, opponents of ILCs might argue that, in difficult times, the commercial affiliates of an ILC will simply violate the law and use the ILC to shore up the commercial affiliates. In this regard, events such as Continental Illinois National Bank's actions in 1987 to support its subsidiary, First Options, in connection with the sharp decline in the equities markets, may be cited, even though Continental was owned by a traditionally regulated bank holding company and First Options was a subsidiary of Continental. The relatively small size of ILCs in comparison to commercial affiliates makes it unlikely that these affiliates would expect to rely on the LLC for funding in times of stress. Further, the sanctions available to the FDIC to punish illegal behavior at an ILC are the same sanctions available to other bank regulators to punish illegal behavior at other banks. These are severe sanctions. If stronger sanctions are needed, they are needed for all banks, not just ILCs that may be affiliated with commercial companies.

**Expansion of the Federal Safety Net**

It also may be argued that the affiliation of ILCs with commercial companies may expand the federal safety net so as to extend any subsidy inherent in the safety net to commercial companies for which it was not intended. This view is premised on the theory that banking institutions perform a valuable credit intermediation role in the economy and that the regulatory structure for banking institutions protects the solvency of those institutions through a safety net that includes the examination process, deposit insurance and access to the Federal Reserve Banks' discount window. This safety net may serve to reduce the costs of funds to banking institutions and, therefore, may serve to subsidize those institutions (a subsidy that is likely passed on to their borrowers). To the extent that banking institutions can pass this subsidy along to commercial affiliates disproportionately, those affiliates may have an advantage over their competitors, which are not affiliated with banking institutions. Although there is some debate about whether the regulatory structure for banking institutions provides a net subsidy, or whether any subsidy is outweighed by the regulatory costs, any net subsidy could only be transmitted to commercial affiliates directly through transactions with those affiliates, such as loans. As noted above, these transactions are strictly limited by sections 23A and 23B of the Federal Reserve Act. Because of these limits, and because ILCs affiliated with commercial companies are quite small relative to the size of the commercial companies, any subsidy that might be passed on directly to commercial affiliates should be nonexistent, or if one exists, be so small as to have no meaningful effect on market competition.

It also might be argued that affiliates of traditionally regulated banking institutions benefit from a "halo effect" that reduces the affiliates' own costs of funds in the markets due to the affiliation with the regulated banking institution, even though the affiliates themselves are not regulated. While we are not aware of any evidence to support this argument with respect to commercial affiliates of ILCs, the idea that debt prices at large commercial affiliates will be affected materially by the existence of a relatively small ILC seems unlikely. Were such a "halo effect" to exist, it would almost surely be so small or transient as to have no effect on the competitive position of the commercial affiliates.

**Unfair Competition**

Moreover, it may be argued that permitting commercial companies to affiliate with ILCs places other banking institutions, and their affiliates, that are in traditionally regulated holding companies, at a competitive disadvantage because of the regulatory requirements that apply to those holding companies. These requirements include the activity limitations that apply to bank holding companies and savings association holding companies. Similar "level playing field" arguments are often raised by regulated entities; however, as a practical matter, differences in regulatory structures create unavoidable differences in competition that can only be eliminated by eliminating all of the regulatory differences. For example, national banks, state banks that are members of the Federal Reserve System and state banks that are regulated by the FDIC are subject to different regulatory schemes that the individual banking institutions have chosen for reasons that they perceive to be in their own interests. Savings associations are subject to a still different scheme. The only way to create a completely level playing field among these institutions is to consolidate their regulation in a single entity under a single set of rules.

ILCs are currently permitted broader affiliations than those permitted to commercial banks or new savings associations, but ILCs of any size are not permitted to hold corporate checking accounts. Accordingly, ILCs cannot provide corporate customers, even small businesses, with the cluster of banking services provided by commercial banks. For this reason, ILCs tend to offer specialized services and are not serious competitors for the corporate business that traditionally has been the hallmark of commercial banking. Indeed, the competitive playing field for banking services is tilted sharply in favor of commercial banks and against ILCs.

**A Note on Synergies**

It is possible to argue that in the case of financial services, the Gramm-Leach-Bliley Act ("GLBA") permits affiliations between banks, securities firms and insurance companies, despite the concerns discussed above, because of synergies between these related financial services companies, but that these synergies do not exist between commercial companies and the financial services that might be offered by affiliated ILCs. Essentially, this argument assumes that there is not a close enough relationship between ILCs and commercial companies, while the above arguments are premised on the view that this relationship is too close. Nevertheless, the long history of retail credit in the United States, including private label credit provided by third parties, is ample evidence of the synergies between financial and commercial transactions.

**Where Do We Go From Here?**

Finally, and more broadly, the issue of affiliations between banks and commercial companies ultimately is likely to be a question of the appropriate regulatory structure, rather than whether such affiliations are to be permitted at all. The GLBA recognized the synergies between different types of financial institutions and developed a regulatory structure to address the risk, subsidy and competition issues discussed above. Prior to the passage of the GLBA, financial innovation had led to an increasing overlap between services offered by banks, securities firms and insurance companies. In many situations, products that are offered were primarily distinguishable by their name or regulator as opposed to economic characteristics. The distinction between commercial transactions and financial services has never been simple. A sale of goods that involves anything other than a contemporaneous exchange of goods for legal tender includes a credit component. Similarly, a national bank's ability to act as a finder incorporates elements of the sale of goods. Innovations in technology and market practices will continue to erode the distinction between commercial and financial transactions. Banking institutions will want to expand their activities into commercial areas and commercial companies will continue to explore ways to offer financial services. In the interim, ILCs offer a laboratory for exploring the appropriate regulatory structure for these relationships in a measured way that is unlikely to put at risk either the stability of the financial system or the quality of competition in the commercial sector.

If you have any questions concerning this comment, feel free to contact me, at (202) 778-1614.

Sincerely,

Oliver I. Ireland