CapitalSource

CAPITALSOURCE BANK

2180 South 1300 East
Suite 300
Salt Lake City, Utah 84106
Phone: (801) 656-1801

October 9, 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 CapitalSource Inc., on behalf of CapitalSource Bank (pending application) in response to the request for public comment on industrial loan corporations issued by the FDIC on August 29, 2006. We appreciate the opportunity to provide this information and hope you find it helpful.

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

CapitalSource is a specialized commercial finance company offering asset-based, senior, cash flow and mezzanine financing to small and mid-sized borrowers. As a financial services provider, we currently compete against many banks. As an applicant under review for an ILC charter, we support strong, yet fair and reasoned regulatory oversight as this will preserve the integrity of the institution, the charter and the industry.

While the ILC industry has grown significantly in recent years, the FDIC and the Utah Department of Financial Institutions have fostered an excellent safety and soundness record for the ILC industry. 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 highly effective in regulating relationships and transactions with affiliates and insulating banks from affiliation risks generally.

The "bank-centric" regulatory model used by the FDIC, which focuses on a bottom-up approach to regulating the institution and its affiliates with which it conducts business, fits well within the modern financial services markets, and has proven effective in controlling relationships and transactions between banks and their affiliates.

Given the excellent safety and soundness record the FDIC and the Utah Commissioner have established following the bank-centric model, we believe the FDIC has adequate authority and flexibility to continue to regulate ILCs in this manner, and adjust to evolving changes on an institution-by-institution basis. We do not believe any systemic modifications are needed for the FDIC to continue to adequately regulate an ILC's activities or to address any risks from an ILC's parent by exercising safety and soundness controls from the ILC level.

2. Do the risks posed by ILCs to safety and soundness or to the Deposit Insurance Fund differ based upon whether the owner is a financial entity or a commercial 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 recognize that risks faced by financial entities can differ from those faced by commercial entities, just as risks faced by small community banks can differ from those faced by large banks. However, the fact that an entity may face different risks than another does not, by itself, cause the entity to be inherently less safe and sound. While some contend that an ILC owned by a commercial entity could face risks such as a loss of depositor confidence due to poor financial results in the parent's commercial endeavors, the diversification of interests of commercial owners of an ILC can also serve as a source of strength in times of challenge for the financial sector.

We believe that the FDIC's supervisory approach, with its emphasis on risk management tailored appropriately for each institution, should be applied consistently across the ILC industry, to both commercial and financial companies. It is far more important to look at the risk profile of each individual depository institution and regulate them accordingly.

Notwithstanding the foregoing, if the FDIC decides to apply its authority differently to financial owners of ILCs, we believe a reasonable way for the FDIC to determine when an entity is "financial" is by following the definition of "financial in nature" and "predominantly engaged in financial activities" established in the Gramm-Leech-Bliley Act and codified in section 4 of the Bank Holding Company Act (12 U.S.C. § 1843). Under section 4(n)(2) of the BHC Act, a company is "predominantly engaged in financial activities" if at least 85% its annual gross revenues is derived from the conduct of activities that are "financial in nature" or "incidental to a financial activity" as defined in section 4(k)(4) of the BHC Act. Using an 85% test based on the definition of financial in nature in the BHC Act would provide a uniform and clearly defined standard that would continue to progress as the Federal Reserve Board and Department of Treasury determine additional activities to be financial in nature. Such a test would also be consistent with Congressional intent.

The FDIC might also consider providing some mechanism for it to determine, for purposes of ILC ownership, what additional activities should be considered financial in nature, so as to provide some flexibility, while still maintaining a national uniform standard.

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?

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, and that has and can continue to be accomplished under the bank-centric model.

Within the ILC industry, banks holding more than 90% of all industrial bank assets are owned by holding companies subject to consolidated regulation by the SEC, Federal Reserve, or the OTS. However, 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. The FDIC routinely imposes conditions on ILC parents (other than bank holding companies) even if they are regulated by a consolidated regulator, and the FDIC directly enforces laws and regulations against affiliates if needed. The FDIC's active regulation of a holding company and non-bank affiliate(s) is only limited when the bank's owner is a bank holding company, and as such is regulated by the Federal Reserve. The FDIC is also limited in its ability to regulate affiliates that have no connection with the bank other than common ownership. Thus, in cases where such affiliates are not subject to consolidated supervision by the OTS or SEC, there is no oversight of those entities, and accordingly, it may be appropriate for the FDIC to consider the extent to which a holding company and affiliates are regulated by another regulator and exercise its authority to impose conditions on the approval of an application to ensure adequate regulation of relevant affiliates when another regulator will not cover that area.

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?

We believe the FDIC should explore any and all factors potentially affecting the safety and soundness of an ILC, public convenience and needs, and the safety of the banking system in the same manner it would when evaluating any other bank. It is entirely appropriate for the FDIC to evaluate the reasons why an owner wants to organize or acquire a bank, the likelihood that the bank will operate safely, honestly and fairly, and the owner's competence and reputation for honesty and integrity.

These considerations are well within the statutory factors the FDIC must consider when evaluating applications for deposit insurance and change in control notices.

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

The seven statutory factors listed in 12 U.S.C. 1816 and the similar factors listed in 12 U.S.C. 1817(j)(7) are in many respects broadly worded and should accommodate all of the considerations described previously for the FDIC to consider and address in evaluating notices and applications involving ILCs. These are the factors that Congress has authorized the FDIC to consider.

We believe that each application or notice 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 convenience and needs 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 statutory factors as presently constituted.

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?

As stated previously, we believe that each applicant should be evaluated on its own merits and approval should be a function of the applicant's ability to address the seven statutory factors in a satisfactory manner. We do not oppose the imposition of conditions, as may be appropriate and applicable to specific applications.

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?

We believe current law does not support a blanket limit of ownership of ILCs to financial companies. We believe the FDIC has adequate authority to impose conditions, on a case-by-case basis, to protect an ILC and the Deposit Insurance Fund from any risks that the FDIC believes are present, based on whether the ILC is owned by a commercial or financial parent. For instance, if the FDIC found reason for concern about commercial affiliates of ILCs, rather than banning commercial owners, it could impose a condition or regulation with more stringent 23A restrictions on transactions between an ILC and its commercial affiliates, such as the OTS's rule that no loans or extensions of credit may be made to affiliates unless the affiliate is engaged solely in financial activities. See 12 C.F.R. 563.41.

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

Although CapitalSource Inc. is a financial company, we believe that the current regulatory regime limits any greater likelihood of conflicts of interest or tying if the ILC parent is a commercial company or not subject to consolidated Federal supervision. These laws and regulations limit the amounts and types of transactions that may occur between a bank and its affiliate(s). These limits make it no more likely that a commercial parent could cause conflict of interest or tying. This is true under any regulatory supervisory model.

As discussed previously, we feel strongly that the existing bank-centric model is wholly adequate and gives the FDIC the authority to monitor risk and the activities of the parent and relevant affiliates of the bank, by virtue of Sections 23A and 23B of the Federal Reserve Act and the anti-tying provisions of the Bank Holding Company Act. These provisions provide the FDIC with the statutory basis to address any additional conflicts of interest that may arise between an ILC and its commercial affiliates. We believe the FDIC has the expertise to identify risk and the authority to address safety and soundness concerns of both de novo applicants and established ILCs. This authority can and should be exercised to control perceived risks of an applicant's business plan.

As stated previously, we do not believe that the FDIC requires additional regulatory authority to adequately control these risks.

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?

Whether an institution enjoys a competitive advantage over another depends on a number of factors. We do not believe that evaluation of or generalization about one factor alone, such as the nature of the parent of an ILC, could accurately reflect the competitive landscape.

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

Although CapitalSource Inc. is a financial entity, we believe there could be public benefits when a bank is affiliated with a commercial concern. If such benefits were evident in the application for deposit insurance when the FDIC assesses the convenience and needs of the community to be served, then the FDIC should consider those benefits.

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?

Given the proliferation of ILCs, the scope and benefits of the Community Reinvestment Act have increased. ILCs and their parent companies, many of which would otherwise not be subject to the CRA, have invested literally millions of dollars back in to their communities in the form of donations, grants and low interest rate loans. The recipients of these funds are, for the most part, low to moderate income individuals, entities and communities. Additionally, ILCs provide a variety of needed services in their communities, such as financial education and literacy, much of which is targeted towards students and young adults. Thousands of hours of community service are provided each year by the ILC industry. Many financial literacy programs would go unfunded if it were not for the generous contributions from ILCs. These very important community contributions should be recognized as another positive component of the vital role that ILCs play in the debate as to their validity in the financial services marketplace. Any steps taken to limit ownership of ILCs would also limit the benefits gained through the Community Reinvestment Act activities of these institutions.

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?

We believe the FDIC has the authority to place restrictions on owners and relevant affiliates of industrial banks to ensure the safety and soundness of the bank. This authority can be exercised through conditions of approval of an application and examination recommendations enforceable through supervisory administrative actions, as necessary. However, we do not believe the FDIC could impose restrictions on the owners of industrial banks that are not authorized by law, especially if they would effectively repeal the exemption for ILC owners in the Bank Holding Company Act. In addition, we believe that current law does not give the FDIC authority to implement a consolidated holding company regulatory regime over ILCs.

Respectfully submitted,

David J. Sharp
President
CapitalSource Bank