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October 10, 2006

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Federal Deposit Insurance Corporation
550 17th Street, N.W.,
Washington, D.C. 20429
Att: Comments

Re: Industrial Loan Companies and Industrial Banks

These comments are submitted in response to the FDIC's August 23, 2006 Notice and Request for Comments about industrial loan banks (71 Fed. Reg. 49456).

Morgan Stanley Bank is an industrial bank chartered in the state of Utah and supervised by the FDIC and the Utah Department of Financial Institutions. Its holding company, Morgan Stanley, is supervised as a "consolidated supervised entity" by the Securities and Exchange Commission and as a "unitary thrift holding company" by the Office of Thrift Supervision. Morgan Stanley and its nonbank affiliates are also subject to examination by the FDIC (pursuant to Section 10(b) of the FDI Act) and the Utah Department of Financial Institutions (pursuant to Utah Code Annotated, Section 7-1-510).

We are pleased to respond to the FDIC's questions about the regulation of industrial banks and their holding companies. We fully expect that the request will generate a number of negative responses cloaked as "concerns" about bank safety and soundness or Deposit Insurance Fund risk from competitor banks and their trade associations who see this review as an opportunity to hobble if not eliminate industrial bank competition.[1] But

[1] One former FDIC Board member recently observed that there is "a virtual total lack of evidence in the U.S. that affiliations between banks and nonbank firms present serious threats to the banking system. [Critics] are very frequently motivated less by philosophy than by a desire to segment markets in order to

we are confident that the FDIC's objective review will demonstrate that these institutions operate in a safe and sound manner and that the existing supervisory regime for industrial banks and their owners continues to be more than adequate to protect depositors and the insurance system.

Although a number of the questions on which the FDIC seeks comment explore issues not directly pertinent to Morgan Stanley Bank, we think that all of them raise important issues and will respond to all.

> *Q. 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?*

Changes in the deposits or assets of the industrial bank industry, the entities that control industrial banks, and the lending activities of these banks have not negatively altered the risk profile of these institutions relative to that of other banks. If anything, these changes, coupled with the supervisory regime that has evolved in response to them, have strengthened the industry and reduced risk. Testifying at a recent Congressional hearing on industrial banks, an industry expert observed that industrial banks today are "the safest and soundest group of banks that has ever existed."[2] We are aware of no evidence to the contrary.

True, the deposits and assets of the industrial bank industry have increased over the past two decades. But because of growth of the banking industry as a whole, the industrial bank sector today holds under 2% of U.S. bank deposits.[3] The banking industry is dominated increasingly by a handful of trillion-dollar bank holding companies that hold a significant percentage of the nation's deposits and assets, and operate a large percentage of its branches. A number of these large institutions hold deposits that are many times larger than the deposit base of the entire industrial bank sector (and the Deposit Insurance Fund). Just as these developments have not triggered a call for a re-evaluation of the supervisory or regulatory structure applicable to the largest institutions, growth of the

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diminish competition." (John D. Hawke, former Comptroller of the Currency, quoted in *American Banker*, November 17, 2005).

[2] Statement of George Sutton before House Subcommittee on Financial Institutions and Consumer Credit, July 12, 2006. Mr. Sutton is the former Utah Commissioner of Financial Institutions.

[3] Industrial banks "comprise a relatively small share of the banking industry – numbering less than one percent of the total 8,700 insured depository institutions and 1.4 percent of the assets." Statement of Douglas H. Jones, Acting FDIC General Counsel , before House Subcommittee on Financial Institutions and Consumer Credit, July 12, 2006.

industrial bank sector is not justification for changing the regulatory structure for these banks.

Opponents of industrial banks occasionally suggest that when Congress initially excluded the owners of these institutions from bank holding company regulation (through a provision of the Competitive Equality Banking Act of 1987) it did so because the institutions were small in number and size. There is nothing in the legislative history of the industrial bank exception that supports this. Moreover, it is clear that in cases where Congress has been concerned about growth it addresses that concern directly with explicit limitations. Indeed, a provision in the same law that created the industrial bank exemption also codified a comparable exemption for so-called "non-bank banks" but included an express limitation on asset growth (to 7% annually) for those institutions. Similarly, when Congress became concerned about concentration of deposits in the largest banks, it addressed that with an explicit statutory limitation on the percentage of insured deposits that may be held by a single institution (Section 101 (d) (2) (A) of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994).

The ownership of industrial banks (and other insured depository institutions) by companies that engage in nonfinancial or commercial activities is nothing new. The recent application for an industrial bank by the world's largest retailer has generated a firestorm of protest (much of it from entities whose expertise has focused heretofore on such activities as labor relations and the operation of convenience stores). Yet an industrial bank charter was obtained nearly two decades ago by the then-largest retailer, while other retailers and non-banking firms have owned thrifts, limited-purpose banks ("non-bank banks") and credit card banks for years, all without harm to the Deposit Insurance Fund.

Under the Gramm-Leach-Bliley Act, Congress approved bank affiliations with investment banks, securities firms, and insurance companies and permitted financial holding companies to engage in commercial activities such as merchant banking and activities "complementary" to financial activities.[4] Coupled with recent regulatory approvals of such activities as the ownership by banks of hotels, condominiums, and windmill farms,[5] this suggests an increasing level of comfort with affiliations and activities that once were impermissible. These approvals have not triggered a re-evaluation of the adequacy of the Bank Holding Company structure. By the same token, changes in the ownership of industrial banks should not be a cause for heightened concern about the FDIC supervisory model, much less for abandoning this successful regime.

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[4] According to the Federal Reserve Board, a "complementary" activity as one that "appears to be *commercial rather than financial* in nature, but that is meaningfully connected to a financial activity such that it complements the financial activity." Board Order approving notice by UBS, AG to engage in commodities activities (January 27, 2004) (emphasis added).

[5] See, e.g., OCC Interp. Ltrs. 1044, 1055 and 1048 (December, 2005)

As the FDIC is aware, despite the interest of some commercial firms in the industrial bank charter, the principal development over the past two decades is not a massive growth in commercially owned industrial bank assets. Today, most of the industry's assets and deposits are held by institutions whose owners are highly capitalized companies that engage exclusively or principally in financial services activities (e.g., Morgan Stanley, Merrill Lynch, Goldman Sachs, and American Express). As a result, more than 90 percent of industrial bank industry deposits are held by entities subject to consolidated supervision by U.S. financial regulators, including the Securities and Exchange Commission, the Federal Reserve Board and the Office of Thrift Supervision.[6]

Notwithstanding concerns about hypothetical problems that could arise from the growth or ownership of industrial banks, the FDIC's long regulatory experience with these institutions, whether owned by financial or commercial entities, demonstrates that these banks have not posed a danger to the deposit insurance system, bank customers or competitors. The Corporation's ability, in conjunction with state and federal regulators, to supervise these banks and to address issues involving their holding companies has been enhanced over the years through legislative changes in the FDIC's mission and authority. These include the "prompt corrective action requirements" of the FDIC Improvement Act of 1991, and the agency's own efforts over time to fine tune and focus its supervision of industrial banks and their owners. The existing regime is demonstrably suitable for the task, and the case has not been made that the FDIC needs to abandon or modify it.

> *Q. 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?*

Industrial banks do not pose a risk to the Deposit Insurance Fund that differs from that posed by any other charter, whether owned by a financial or a commercial entity. The FDIC has known this for years. Nearly two decades ago, it advocated repealing the Bank Holding Company Act's activities and affiliations restrictions on the ground that they were not necessary to enhance the safety and soundness of the banking system or safeguard the deposit insurance system:

> "[T]here appears to be no historical precedent to suggest that there is a long-standing tradition of separation of banking and commerce. Beyond historical

[6] Eight industrial banks, controlling approximately 70 per cent of total industrial bank assets nationwide, are subject to OTS holding company jurisdiction and oversight. See Letter of OTS Director John M. Reich to Rep. Spencer Bachus (July 11, 2006).

precedent, our review of the evidence does not support the wisdom of separation and thus we find no compelling reasons for continuing it."[7]

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"[S]ystemic risks to the banking industry and potential losses to the deposit insurer will *not* be increased if activity restrictions and regulatory authority over non-bank affiliates are abolished."[8]

More recently, former FDIC Chairman Donald Powell said:

"The FDIC believes that the ILC charter, per se, poses no greater safety and soundness risk than other charters.

Further the firewalls and systems of governance safeguarding ILCs from misuse by their parent companies are, in many cases, more stringent than what exists in many affiliates of bank holding companies." [9]

The U. S. Government Accountability Office reached a similar conclusion:

"[F]rom an operations standpoint, ILCs do not appear to have a greater risk of failure than other types of insured depository institutions." [10]

There is no reason to develop rules for industrial banks that differ from those applicable to banks in general, much less for creating rules for industrial banks that differ depending on the nature of the businesses in which their owners are engaged.

We are aware of no evidence that a entity engaged in nonfinancial activities that controls a bank (whether the owner operates a small community bank, a large thrift institution, or industrial bank) poses a risk to its own institution, or to the deposit insurance system or competitor banks, that warrants either an outright prohibition on the affiliation or the imposition of legislative/regulatory restrictions that go beyond those currently in place (e.g., Sections 23A and 23B of the Federal Reserve Act). When Congress (as part of the Gramm-Leach-Bliley Act) permitted commercial banks to affiliate with investment banks and insurance companies it recognized that potential abuses (like preferential lending or tying) that once justified a ban on such affiliations could be addressed through regulatory restrictions on the abusive conduct rather than by simply prohibiting the affiliation. In the absence of evidence that engaging in nonfinancial activities (either exclusively or

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[7] *Mandate for Change* (FDIC, 1987) , p. 98.

[8] *Mandate for Change*, p. 102.

[9] Remarks of FDIC Chairman Donald E. Powell to American Bankers Association, May 30, 2003.

[10] "Industrial Loan Corporations" GAO-05-621 (September, 2005).

occasionally) creates dangers that are not addressed by current requirements, there is no basis for adopting new ones.

Q. 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?

The FDIC has consistently taken the view that, for purposes of fulfilling its mission of safeguarding the nation's bank deposits, its "bank centric" supervisory model is superior to consolidated holding company supervision. This position is borne out by the agency's decades of successful experience in examining industrial banks and their owners and affiliates, as well as other institutions that do not have a consolidated holding company supervisor. The clamor generated in Congress and at the FDIC by the well-financed campaign of opponents of industrial banks, has not produced a single instance where the FDIC's model has failed or a consolidated holding company model would have worked better.

The FDIC does not differentiate between other banks it examines based on whether or not their owners are subject to bank or thrift holding company supervision, and does not condition deposit insurance application approvals for other banks based on whether or not the institution's owner is subject to consolidated supervision. In the absence of evidence that industrial banks pose a risk to the insurance fund that differs from risks posed by other banks, there is no need to treat industrial banks differently from other banks based on whether their owners are subject to consolidated supervision.

The FDIC's experience with Morgan Stanley Bank is an illustration that there is no link between the safety and soundness of a bank (or its risk to the Deposit Insurance fund), and the supervisory regime applicable to its owner. When first chartered as an industrial bank, our institution was owned by a commercial firm (Sears, Roebuck & Co.) not subject to holding company oversight. Today our parent company is subject to multiple consolidated supervisors. The FDIC's examinations from the beginning have found the institution's assets, management and other indicia of safety and soundness to be more than satisfactory, and the agency's access to the Bank's holding company and affiliates allowed the FDIC to satisfy itself that holding company activities were not endangering the Bank or the deposit insurance system. Morgan Stanley Bank was operated in a safe and sound manner prior to its parent becoming subject to consolidated supervision, not because of it.

Should new evidence lead the FDIC to the determination that consolidated supervision reduces risk to the Deposit Insurance Fund after all, it might be appropriate to consider this as a factor in assessing risk-based deposit insurance premiums. This standard would apply to all banks. But in the absence of demonstrable evidence that industrial banks present a unique risk, there is no basis for a separate charter-specific rule that applies only to industrial banks. Adopting such a standard would be an arbitrary action that would contravene fundamental principals governing the fairness of the administrative process.

Two further points with regard to consolidated supervision should be mentioned. First, any FDIC evaluation that includes a consideration of consolidated supervision should expressly recognize the Securities and Exchange Commission's "consolidated supervised entity" oversight. The CSE regime allows the Securities and Exchange Commission to evaluate the operations, risk management, capital adequacy and the financial and operational condition of large broker-dealers on an enterprise-wide basis. Covered firms are subject to comprehensive and robust examinations and ongoing oversight of capitalization and risk. Like the Federal Reserve's regime for examining financial holding companies, the SEC's consolidated oversight defers to functional regulators with respect to examinations of holding company affiliates that have financial regulators, but otherwise looks into the operation of all holding company affiliates.

Second, should the FDIC determine, for the first time, that holding company supervision is essential to the protection of the deposit insurance system, there is no need for it to conclude that only *federal* holding company supervision can serve this goal. Holding company supervision and examinations by the state regulators that also examine industrial banks (in coordination with the FDIC) should be deemed at least as effective, if not more so. State examinations permit the same regulators to take a comprehensive look at both the holding company and its insured bank, allow holding company examinations to be targeted at areas of concern to bank examiners and eliminate coordination and communication problems that exist when separate agencies are involved. There is no reason for the FDIC to limit its source of holding company information to data provided by federal holding company regulators.[11]

> *Q.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?*

The FDIC should continue to evaluate industrial bank deposit insurance applications, notices or other applications on the same basis as applications pertaining to other depository institutions. Features about an institution's parent should be taken into

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[11] Congress recognized the role of state supervision in Section 111 of the Gramm Leach Bliley Act, which limits the authority of the Federal Reserve Board to examine or obtain reports from subsidiaries of bank holding companies. It requires the Board instead to accept "to the fullest extent possible" reports provided by "federal *or state* supervisors or appropriate self-regulatory agencies" (emphasis added) and to "forego" examinations of affiliates subject to federal *or state* examinations.

consideration in the same manner as this information is evaluated in connection with other bank charter applications.

> *Q. 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 statutory enumeration of "Factors to be considered" that is set forth in 12 U.S.C. Section 1816 appears to be an exhaustive list rather than a list of examples or a directive to the FDIC to develop additional criteria. The statute says, for example that the factors to be evaluated by the Board "*are* the following" (emphasis added) as opposed to "include the following."

The statutory factors focus on the depository institution applicant and its management, and do not refer to the type of charter held by the applicant, the "nature of the owner," the business activities of the institution's owner, or whether or not the bank's owner is subject to consolidated supervision. The only criterion that arguably relates to an applicant's owner is "the future earnings prospects of the depository institution" which might require a bank whose business plan relied on referrals from its owner to demonstrate that the owner would generate an adequate stream of business.

The seven statutory factors have been utilized in the past in connection with industrial bank deposit insurance applications, and with good results. The FDIC has also used the current factors for decades in evaluating insurance applications by banks that are not controlled by bank holding companies, including institutions that do not have corporate owners or holding companies and institutions controlled by commercial or other entities that are not eligible to become bank holding companies. We do not think there is a basis for adding a new set of criteria for evaluating industrial bank applications in the future.

> Q. *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?

The FDIC does not have the statutory authority to routinely impose restrictions on industrial banks, or categories thereof, that do not apply to other banks. Nor is there a risk-based need to do so. The FDIC's Division of Supervision and Compliance recently noted that charter-specific conditions (standard, nonstandard or prudential) need not be imposed on industrial banks because "[i]n DSC's experience, the type of charter under which an institution is organized, in and of itself, is not a determinant of risk...."[12]

From time to time, Congress has, by statute, imposed statutory restrictions on specified types of institutions. The Competitive Equality Banking Act of 1987 prohibited industrial banks from offering demand deposit accounts, and prohibited them from allowing affiliates to incur "daylight overdrafts." [13] The same law imposed restrictions on so-called "non-bank banks" (e.g., a restriction on increasing assets by more than 7% annually, and limitations on cross marketing and new banking activities[14]). More recently, the House of Representatives considered other legislative limitations on industrial banks owned by "commercial" firms (e.g., restrictions on interstate branching and the payment of interest on NOW accounts offered to business customers) that have not been enacted. Each of these actions reflects a clear recognition that the legislative process, not action by the FDIC by order or regulation, is required to impose limitation on all, or a subset of, industrial banks.

Aside from the absence of statutory authority to target one class of banks with growth, branching or other restrictions is the question of whether there is any reason to do so. Industrial banks, for nearly a century, have had the same authority as other depository institutions to increase their deposits and assets and to establish branches (though the ability to operate branches has rarely been used). No problems have arisen from the exercise of this authority that signal the need to curtail it.

Of course, the FDIC has the authority to impose certain restrictions on any individual institution, including an industrial bank, if warranted by that institution's circumstances. For example, the FDICIA "prompt corrective action" provisions (12 USC Section 1831o) authorize the FDIC to order an institution to take such steps as curtailing growth, reducing assets, and terminating activities if it becomes "significantly undercapitalized." And if an individual charter applicant elected to refrain from exercising its right to grow or to operate branches, and to make a commitment to the FDIC not to do so, there would seem to be no reason for FDIC to object. But this is a far cry from imposing across-the-

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[12] Memorandum of Sandra L. Thompson, Acting Director, DSC to Steven M. Boyd (July 17, 2006) (FDIC Office of Inspector General Report No. 06-614 (July 2006), Appendix XI).

[13] This restriction was liberalized by the Gramm-Leach-Bliley Act, which limited it to overdrafts incurred by or on behalf of, non-financial affiliates.

[14] This asset growth cap was repealed in 1996, as a result of bipartisan legislation co-sponsored by Reps. Castle, Frank and others. The other restrictions, as well as a penalty provision that applied to industrial banks and CEBA non-bank banks, were repealed under the Gramm-Leach-Bliley Act (1999).

board growth, activities or other restrictions on a class of well-capitalized and managed institutions merely because of the type of charter it holds, the businesses in which its owner engages, or the manner in which its parent is regulated.

Q. 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?

To the extent that the FDIC identifies specific characteristics or conduct that pose a danger to the Deposit Insurance Fund, limitations on that conduct - applicable to **any** institution that engages in it – would be the appropriate response. However, there is neither statutory authority, nor a factual basis, for the FDIC to impose charter-based conditions or regulatory limitations that target industrial banks alone.

Q. 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?

Dangers of conflicts of interest and tying exist whenever a depository institution is owned by, or is affiliated with, another entity, financial or commercial. The temptation to favor affiliates or to discriminate against customers of competitors is equally present in money-center banks operated by financial holding companies, small community banks whose owners run local businesses (commercial or financial), or thrifts and industrial banks with commercial or financial owners or affiliates. The FDIC's historical experience demonstrates that the industrial bank charter does not represent a unique or enhanced risk of unlawful tying or conflict, and we are confident that the FDIC's current examination of this issue will not uncover information that would raise concerns about the future.

Conflicts and tying, like other prohibited practices, have always been best addressed by clear prohibitions, effective examinations, and strong sanctions. The dangers are further reduced through policies that encourage competition in the banking industry, so that bank customers have optional sources of financial services and can avoid exploitation by institutions that might yield to the temptation to engage in tying or other prohibited practices. (Limiting the industrial bank charter would, of course, be inconsistent with enhancing banking industry competitiveness.) Addressing conflicts or tying through limitations imposed on the industrial bank sector alone is not necessary, given the absence of any real or potential problems or evidence that the FDIC's existing authority (and its continued focus on affiliate transactions and other areas where conflicts might exist) are insufficient.

Q. 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?

Industrial banks with commercial owners are, of course, subject to a different form of holding company supervision than some other depository institutions, and are not subject to the activities restrictions that apply to institutions owned by bank holding companies (and to a lesser extent, financial holding companies).[15] But whether these differences amount to a competitive advantage is questionable.[16] The fact that there has never been a movement by commercial banks to operate as industrial banks, or a serious effort by them to remove the statutory activities restrictions that supposedly disadvantage them, (but serve to deter entrants to the banking business) is perhaps the best indication that the supposed competitive advantage is more of a debating point than a practical reality.[17] Opponents of industrial banks seem far less interested in leveling the playing field than in clearing industrial banks from it.

In any event, the FDIC's role in safeguarding bank deposits does not require it to pick winners and losers among competing institutions or to help segments of the banking industry suppress competition. "Competitive advantage," if it exists, is relevant to the FDIC's mission only to the extent that it can be shown to endanger the Deposit Insurance

[15] Recently, opponents of industrial banks have claimed that another competitive advantage exists in that industrial bank holding companies, unlike financial holding companies, are not subject to a statutory requirement to maintain "well capitalized" depository institutions and "satisfactory" Community Reinvestment Act ratings. (They do not mention that this "advantage" applies as well to any bank or bank holding company that has not elected to become a financial holding company, a group of institutions that far exceeds the small number of industrial banks.) The implication that industrial banks have exploited these differences is false. As the FDIC is well aware, industrial banks, notwithstanding the absence of a statutory requirement, have a history of operating as "well capitalized" entities and a CRA record superior to that of the banking industry as a whole. For example, nearly 40% of the Utah industrial banks examined for CRA compliance by the FDIC have achieved "Outstanding" CRA ratings.

[16] "Indeed, the competitive playing field for banking services is tilted sharply in favor of commercial banks and against ILCs." October 2, 2006 comment letter filed in this proceeding by Oliver I. Ireland, former Associate General Counsel of the Board of Governors, Federal Reserve System.

[17] It should be noted that the "competitive advantage" concern advanced by opponents of industrial banks is flatly inconsistent with their argument that industrial banks are susceptible to failure and a threat to the insurance fund. Competitors should not fear competition from institutions on the verge of collapse.

Fund. This might be the case if it could be shown that an industrial bank owned by a commercial firm had a history of exploiting, or threatened to exploit, the supposed advantage to the detriment of other banks, driving them to failure. However, there is no factual support, anecdotal or otherwise, for this concern.[18] Proponents of the competitive advantage rationale are undeterred by the fact that owners of industrial banks that engage in commercial activities, like the owners of thrifts, credit card banks, "non-bank banks," community banks and other charters, have operated these banks for years without using their exemptions from bank holding company regulation to dominate the industry, or drive competitors to insolvency.

There is no need to address the potential exploitation of an alleged competitive advantage through limitations on the availability of industrial bank charters or the regulatory process. The insurance application process considers the impact of an applicant on the market share and business lines of other banks as bearing on the "convenience and needs of the community." Evidence of anticompetitive behavior that affected the deposit insurance system or other institutions would clearly be pertinent to this evaluation. Thereafter, should the examination process reveal anticompetitive activity by a depository institution that endangers the Fund, the FDIC's existing authority permits appropriate responses.

> *Q. 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?*

Banks owned by commercial companies and those owned by firms like Morgan Stanley that engage in some nonfinancial activities, but do not do so predominantly,[19] provide

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[18]The Government Accountability Office's report on industrial banks (GAO-05-621) failed to uncover any examples either. GAO criticized the adequacy of the FDIC's "bank centric" supervision anyway, explaining that the FDIC's supervisory experience has occurred mostly in good times for the banking industry, but might prove inadequate in times of stress. This rationale ignored decades of successful FDIC experience with industrial banks in both good times and bad. If taken seriously, it would also call into question the adequacy of the "financial holding company" model established in 1999 under the Gramm-Leach-Bliley that has existed *only* during the same "good times."

[19] There is no commonly understood standard for defining a "commercial" firm or "commercial" activities. While that term might reasonably be thought to describe only firms that derive their revenues principally from certain commercial or industrial activities, some sectors of the banking industry have urged a narrow definition that would define as "commercial" any firm that derives more than *15%* of its revenues from activities that are not "financial in nature" or "incidental" to a financial activity. This definition is based *in part* on the Bank Holding Company Act's list of activities permissible for a financial holding company (the BCHA , but not this definition, also includes commercial activities that are "complementary" to a financial activity). Thus, this definition would classify as "commercial" some activities that are permissible for a financial holding company. Supposedly designed to prevent large retailers from entering the banking business, this definition would also exclude financial services companies that engage in nonconforming activities, a result that perhaps is not inadvertent.

benefits both to bank customers and to the deposit insurance system. Customers benefit from the availability of alternative sources of banking services and the product and service innovations that these banks and their owners bring to the banking industry. They benefit from the convenience of accessing services from affiliates of firms with which they have existing customer relationships, and from the positive impact on financial services pricing that these banks bring to the marketplace (a benefit that helps customers of other banks as well as those who do business with industrial banks). Customers also benefit from these affiliations in a less tangible way, to the extent that they allow owners of these institutions to reduce their banking costs and pass the savings along to customers. In evaluating an industrial bank charter application, the FDIC could properly consider these benefits as fostering the convenience and needs of the community.

The affiliation of a bank with entities engaged in commercial or nonfinancial activities arguably also has a positive impact on the deposit insurance system. This is principally because of the ability of these other entities to serve as a source of strength to the bank when necessary, reducing the risk of failure and the need to draw on the Deposit Insurance Fund.[20] Unlike many bank holding companies whose activities are limited to bank ownership and have no additional resources to provide to a troubled bank subsidiary, commercial or diversified firms that control banks typically have revenues and resources that far exceed those of their subsidiary banks. These can be, and are, made available to a troubled depository institution when necessary. As the FDIC is aware, the frequently cited scenario of a commercial/diversified industrial bank owner plundering bank assets to prop up a failed parent or affiliate does not reflect reality. On the other hand, there have been several real life examples of owners of industrial banks downstreaming resources to prevent losses to their banks, and examples of industrial owners that have gone into bankruptcy while their industrial bank subsidiaries have survived unharmed and have even been sold at a premium.

> *Q. 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?*

One area of inquiry might be into the impact of measures that would have the effect of curtailing the industrial bank industry on the dual banking system. While industrial banks are a minor part of the banking industry as a whole, the industrial bank charter is a growth area for the state banking segment. Indeed, former Assistant Treasury Secretary Wayne Abernathy characterized industrial banks as "emblematic of the kind of variety

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[20] One of the lessons of the thrift industry collapse of the 1980s was the ability of commercial owners of these institutions to serve as a source of strength and avert failures. See Lawrence J. White "The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation" (1991). Earlier, the ability of commercial companies to own banks helped the banking industry emerge from the collapse that precipitated the Great Depression.

that we have in financial institutions because of the innovation that our dual banking system allows."[21]

Proposals to prevent commercial companies from chartering industrial banks would directly limit the growth of these state chartered institutions to the detriment of the state charter and the dual banking system. The proposal to require all industrial banks owners to register as bank holding companies directly excludes commercial companies from charter eligibility and would indirectly drive most commercial firms from the industry. While financial firms (at least those that were willing and able to comply with the activities restrictions of the Bank Holding Company Act) would theoretically be allowed to own or acquire industrial banks, it is more likely that such firms would choose to operate national banks, not industrial banks.

The deposit insurance system has been strengthened by the membership of different types of depository institutions, state and federal, that help to diversify risk. The elimination in 1999 of the ability of nonfinancial companies to acquire thrifts may have been a victory for some sectors of the banking industry, but it did not provide benefits to bank customers or enhance the deposit insurance system. Restricting the industrial bank charter would accelerate the trend towards national bank charters and the consolidation of bank deposits in the largest national banking institutions. [22]

> *Q. 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?*

The statute does not authorize the imposition of a consolidated supervision requirement on a single type of bank charter. Industrial bank owners, along with entities that control other types of depository institutions (e.g., non-corporate owners of banks including groups of banks internally known as "chain banking organizations" by the FDIC, owners of grandfathered "unitary thrifts," credit card banks, or so-called "non-bank banks") have been exempted by Congress from Bank Holding Company Act regulation. There is nothing in the Bank Holding Company Act or the Federal Deposit Insurance Act that authorizes the FDIC to impose a consolidated supervision requirement on any of these exempted institutions. Nor do the statutory factors Congress adopted for the evaluation of deposit insurance applications include a consolidated supervision requirement.

Should the FDIC, contrary to its historical experience, conclude that an institution not subject to consolidated supervision imposes a different risk to the deposit insurance

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[21] Testimony before the Subcommittee on Financial Institutions and Consumer Credit (March 5, 2003).

[22] "The power inherent in an institution's freedom to choose is at the very heart of our free market system; institutions must have the ability to choose the charter that best meets their business needs and their customer's needs." Diane M. Casey, President and CEO of America's Community Bankers (*American Banker, January 18, 2002, p. 5)* (writing on the thrift and national bank charters).

system than other banks, that difference could be taken into account in assessing risk-based deposit insurance premiums, as well as through the supervisory process. There is no reason to address it by imposing limitations only on institutions that hold a specific charter.

Conclusion

The recent controversy surrounding industrial loan banks appears to be driven largely by fears, trade association politics and agendas that have little to do with facts. Morgan Stanley Bank appreciates the FDIC's determination to examine issues surrounding the ownership and operation of these banks in a deliberative and dispassionate manner. We believe that the Corporation's objective analysis of these issues and its historical experience with the industrial bank industry will compel the conclusion that the supervisory regime it has developed continues to protect and advance the interests of bank customers, the U.S. economy and taxpayers. The FDIC's ongoing practice of monitoring the effectiveness of its oversight of industrial banks and making adjustments to its supervisory program when warranted has allowed it to keep abreast of changes and growth in the industrial bank industry. Any deficiencies that are identified in this successful oversight model can and should be addressed by fine-tuning it, rather than by abandoning it.

Sincerely,

Morgan Stanley Bank

by Susan E Carroll
Susan E. Carroll
President